INDEX

	Page
Opinion below	1
Jurisdiction	2
Question presented	2
Statute involved	2
Statement	2
Specification of errors to be urged	6
Reasons for granting the writ	7
Conclusion	17
Appendix A—Opinion and judgment below	1a
Appendix B—Statute involved	30a
Appendix C—Conflicting opinion—*John Kelley Co.* v. *Commissioner of Internal Revenue*, 326 U.S. 521 (1946)	31a
Appendix D—Case misapplied by Lower Court—*Gregory* v. *Helvering, Commissioner of Internal Revenue*, 293 U.S. 465 (1935)	40a

CITATIONS

CASES:

Bazley v. *Commissioner of Internal Revenue*, 331 U.S. 737 (1947)	10
Chisholm v. *Commissioner of Internal Revenue*, 79 F. 2d 14 (CA-2, 1935), *cert. den.* 296 U.S. 641 (1935)	12
Court Holding Company v. *Commissioner of Internal Revenue*, 324 U.S. 331 (1945)	14
Electrical Securities Corporation v. *Commissioner of Internal Revenue*, 92 F. 2d 593 (CA-2, 1937)	12
Gregory v. *Helvering*, 293 U.S. 465 (1935)	5, 6, 10, 12, 13, 40a
Griffiths v. *Commissioner of Internal Revenue*, 308 U.S. 355 (1940)	10

Page

Helvering v. *Alabama Asphaltic Limestone Company*, 315 U.S. 179 (1942) 10
Higgins v. *Smith*, 308 U.S. 473 (1940) 10
Ingle Coal Corporation v. *Commissioner*, 10 T.C. 1199 4
Ingle Coal Corporation v. *Commissioner*, 174 F. 2d 569 (CA-7, 1949) 4
John Kelley Company v. *Commissioner of Internal Revenue*, 326 U.S. 521 (1946) 6, 7, 8, 9, 12, 13, 16, 31a
Lea v. *Commissioner of Internal Revenue*, 96 F. 2d 55 (CA-2, 1938) 12, 15
Lewis v. *Commissioner of Internal Revenue*, 160 F. 2d 839 (CA-1, 1947) 12
Lewis v. *Commissioner of Internal Revenue*, 176 F. 2d 646 (CA-1, 1949) 12
McCandless v. *Furlaud*, 296 U.S. 140 (1935) 9
Minnesota Tea Company v. *Helvering*, 302 U.S. 609 (1938) 10
Survaunt v. *Commissioner of Internal Revenue*, 162 F. 2d 753 (CA-8, 1947) 12
Talbot Mills v. *Commissioner of Internal Revenue*, 326 U.S. 521 (1946) 6
United States v. *Cumberland Public Sales Co.*, 338 U.S. 451 (1950) 13, 14, 15, 16
Upshaw v. *United States*, 335 U.S. 410 (1948) 9

STATUTES:

28 U.S.C., Section 1255 (1) 2
28 U.S.C., Section 4901 6
Section 23(a)(1)(A) of the Internal Revenue Code of 1939 ..... 2, 4, 5, 6, 9, 30a
Section 23(b) of the Internal Revenue Code of 1939 ..... 7, 8
Section 112(g)(1) of the Internal Revenue Code of 1939 10

IN THE

Supreme Court of the United States

October Term, 1955

No.

INGLE COAL CORPORATION, *Petitioner,*

v.

THE UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

(Filed July 29, 1955)

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Claims, entered in the above-entitled case on January 11, 1955.

CITATIONS TO OPINION BELOW

Both the majority and minority opinions of the United States Court of Claims (R. 81-90) printed in Appendix A hereto, beginning on page 1a, is reported in 127 F. Supp. 573.

JURISDICTION

The judgment of the United States Court of Claims was entered on January 11, 1955 (R. 81). The petitioner's motion for rehearing was denied on May 3, 1955 (R. 105). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255(1).

QUESTION PRESENTED

Whether valid overriding royalty payments made in 1947 and 1948 pursuant to an enforceable contract entered into in 1942 are deductible by the payor thereof.

STATUTE INVOLVED

The statute involved is section 23(a)(1)(A) of the Internal Revenue Code of 1939. The provisions of this Section of the 1939 Code are printed in Appendix B, p. 30a.

STATEMENT

Only a question of law is involved. The facts have been stipulated and the Court of Claims summarized them as follows (R. 81)—

"* * * The Ingle Coal Company, plaintiff's predecessor, (hereinafter sometimes referred to as the old corporation) was a family corporation. All its stock was held by members of the Ingle family consisting of two brothers, two sisters, and the children of the brothers. The old corporation was engaged in the business of mining bituminous coal on lands held under a lease (not acquired from the Ingle family) beginning on June 1, 1940. A royalty of five cents a ton was being paid the lessor under the lease. The business had appreciated considerably in value and in the spring of 1942, an offer of $1,000,000 was made to the old corpo-

ration for its assets. The offer was rejected. The stockholders of plaintiff's predecessor decided to liquidate the corporation, transfer its assets and liabilities to the stockholders who would then transfer them to a new corporation to be organized in exchange for the stock of the new corporation and a contract obligating the new corporation to pay named individuals, who were then the stockholders, five cents a ton royalty, in addition to the royalty stipulated in the lease, on the coal thereafter mined under the above lease.

"This plan was adopted and consummated for the purpose of reducing taxes, assuring a more definite income to Katherine I. Mitchell and Frances I. Bebb, two of the stockholders, and allowing the disposition of the stock, for a lesser price, and still retaining an interest in the coal business.

"A stockholders' meeting of the old corporation was held on June 30, 1942, and a resolution was adopted that the corporation discontinue business and that its assets and liabilities be distributed to the stockholders, or their nominee, in proportion to their respective stock holdings. The president and secretary were authorized and directed to make all necessary transfers, conveyances and assignments. The stockholders agreed to accept the proposed distribution, and individually authorized the transfer and conveyance of the assets and liabilities to the plaintiff as their nominee. On the same day the directors of the plaintiff met, and after organizing and electing officers, received and accepted a proposal by the stockholders of the old corporation to convey the assets that had been distributed to their nominee, the plaintiff, to plaintiff in consideration of the assumption by the plaintiff of the

liabilities assumed by them in the liquidation of the predecessor corporation; the issuance of the plaintiff's stock in the same proportion as they had held stock in the old corporation, and also a separate agreement by the new corporation to pay them in proportion to their stock holdings in the old corporation a royalty of five cents a ton on the coal mined under the lease. Four of the stockholders also agreed to subscribe to 500 additional shares of the plaintiff's stock. The necessary legal documents for carrying out the above plan were duly executed.

"The plaintiff paid the named individuals in the contract, who had been the stockholders of the old corporation and were then plaintiff's stockholders, five cents a ton royalty on the coal mined under the lease (hereinafter referred to as over-riding royalties), in addition to the five cents a ton paid to the original lessor, and claimed a deduction therefor under section 23(a)(1)(A) for the period from July 1, 1942, to December 31, 1942, and for the year 1943. The Commissioner of Internal Revenue allowed the royalties paid to the original lessor but disallowed the over-riding royalties. The Tax Court in *Ingle Coal Corporation* v. *Commissioner,* 10 T.C. 1199, held that the over-riding royalties paid to the stockholders under the agreement were not an ordinary and necessary expense and were in substance a nondeductible dividend distribution. The United States Court of Appeals for the Seventh Circuit in *Ingle Coal Corporation* v. *Commissioner,* 174 F. 2d 569, affirmed the Tax Court on the same ground.

"Katherine I. Mitchell, recipient of 25 percent of the over-riding royalties, died on May 5, 1943. Her stock was sold to other stockholders of the plaintiff and

her rights to the over-riding royalties were distributed to her heirs and legatees. On June 28, 1944, Frances I. Bebb, recipient of 25 percent of the over-riding royalties, donated to each of her six nephews and one niece 25 shares of her stock. The gifts upset the equality of the holdings by the David Ingle and William D. Ingle branches of the family. On April 1, 1946, the remainder of her stock was sold and the equality of holdings of the two families was again attained. She retained the over-riding royalty rights.

"The over-riding royalties have been paid continuously each year since July 1, 1942. In addition to such payments dividends were paid in 1947 and 1948 in the amounts of $65,000 and $115,000, respectively.

"On its Federal tax returns for the years 1947 and 1948 the plaintiff claimed, *inter alia,* deductions for the over-riding royalties in the amounts of $42,761.10 and $34,223.70, respectively. The Commissioner disallowed the deduction and assessed an additional tax, which was paid. A timely claim for refund was filed and after six months had expired without the Commissioner's formal rejection this action was instituted."

The United States Court of Claims held that the overriding royalty payments were dividends and were therefore not deductible under the provisions of section 23(a)(1)(A) of the Internal Revenue Code of 1939. In order to hold that the payments were dividends, the lower Court ignored the 1942 reorganization and disregarded the existence of the petitioner corporation, relying upon *Gregory* v. *Helvering,* 293 U.S. 465 (1935), and related cases (R. 87). In so doing, the United States Court of Claims considered the petitioner to be in reality the same as its predecessor and held that the assumption of the obligation to pay the

overriding royalties was gratuitous for tax purposes, concluding that the payments were dividends and not deductible expenses (R. 82-88). However, Judge Madden, in a dissenting opinion concurred in by Judge Whitaker, stated that the overriding royalty payments should be deductible for the following reasons, among others: First, the transaction entered into in 1942 made permanent and important changes in the relations to the petitioner corporation of the persons who were to receive the overriding royalty payments. Second, the petitioner became unconditionally liable to make the payments whether or not it made money on its mining operations, and whether or not the persons owning the royalty rights were stockholders (R. 88-90).

The basis for the jurisdiction of the United States Court of Claims is set forth in 28 U.S.C., Section 4901.

SPECIFICATION OF ERRORS TO BE URGED

The United States Court of Claims erred:

1. In ignoring the decision of the United States Supreme Court in *John Kelley Company* v. *Commissioner of Internal Revenue,* 326 U.S. 521 (1946) and *Talbot Mills* v. *Commissioner of Internal Revenue,* 326 U.S. 521 (1946) although petitioner repeatedly called these cases to the lower court's attention.

2. In misapplying the doctrine of *Gregory* v. *Helvering, supra,* by ignoring the reorganization accomplished in 1942 which gave birth to a permanent functioning corporation on the ground that the reorganization was effectuated to save taxes.

3. In holding that the overriding royalty payments were dividends and not deductible as expenses within the purview of section 23(a)(1)(A) of the Internal

Revenue Code of 1939 although one-half of such payments were made to nonstockholders.

REASONS FOR GRANTING THE WRIT

1. The decision of the United States Court of Claims is in conflict with the decision rendered by the Supreme Court of the United States in *John Kelley Company* v. *Commissioner of Internal Revenue, supra,* which decision is set forth in Appendix C, pp. 31a-39a. In that case a corporation, all of whose common and preferred stock was owned directly or as trustees by members of a family group, was "voluntarily" recognized. This reorganization took the form of a recapitalization by which the stockholders of the corporation received only newly issued debentures in return for their preferred stock. The question before the Court was whether or not the payments on the debentures were deductible under the provisions of section 23(b) of the Internal Revenue Code of 1939 as payments of interest. This Honorable Court refused to disregard the reorganization, stating in part, on page 525:

> "There is not present in either situation *the wholly useless temporary compliance with statutory literalness* which this Court condemned as futile, as a matter of law, in Gregory v. Helvering, 293 U.S. 465. *The demonstrated possibility of sales by the holders of the obligations to persons other than stockholders alone proves the differentiation.* * * *" [Emphasis added.]

The Supreme Court then examined the characteristics of the obligations in question and the surrounding circumstances and determined that the payments

were ones of interest within the purview of section 23(b).

Thus, in both the *Kelley* case, *supra,* and the instant case, there were present "voluntary" reorganizations. The reorganization in the *Kelley* case, *supra,* brought about permanent changes in the corporate setup, and this Court refused to disregard the reorganization. So too in the instant case, the reorganization in 1942 brought about changes which were permanent in nature —a corporation which is still in existence and a contract under the terms of which payments are still being made. There was no "* * * temporary compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering* * * *"[1] In the instant case "* * * The demonstrated possibility of sales by the holders of the obligations to persons other than stockholders alone proves the differentation. * * *"[2] Actually, the facts disclose in the instant case that 50 per cent of the overriding royalty payments made during the taxable years involved were made to nonshareholders.

It is important to recognize that the court below disallowed the deductions of the overriding royalty payments solely on the ground that the new corporation, the petitioner herein, should be disregarded for tax purposes and that, therefore, the payments should be considered to have been made by the former corporation, thus resulting in merely gratuitous payments or dividends. Such disregard of a permanent operating corporation formed in 1942 in order to disallow pay-

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[1] *John Kelley Company* v. *Commissioner of Internal Revenue, supra,* at page 525.

[2] Id.

ments made by that corporation in 1947 and 1948, is clearly in conflict with the *Kelley* case, *supra*. Further, it is evident from the lower court's decision that the payments made do meet the literal requirements of section 23(a)(1)(A) of the Internal Revenue Code of 1939.

Although petitioner heavily relied in its brief and in its oral argument on the *Kelley* case, *supra*[3], the lower court ignored these cases in rendering its decision.

2. Certiorari has been granted where a Court of Appeals or the United States Court of Claims has allegedly misconstrued or misapplied applicable Supreme Court decisions. *McCandless* v. *Furlaud,* 296 U.S. 140 (1935) and *Upshaw* v. *United States,* 335 U.S. 410 (1948). In rendering its opinion in the instant case the United States Court of Claims misconstrued and misapplied decisions of the Supreme Court of the United States. The United States Court of Claims held that the transaction consummated in 1942 *had no genuine business purpose and was simply motivated by personal reasons.* Continuing, the court held that the transaction in 1942 was thus without substance. Therefore, the court ignored the 1942 transaction and disregarded the existence of the petitioner corporation. Concluding, the court held that the overriding royalty contract should therefore be treated the same as if the petitioner's predecessor corporation had assumed the obligation of paying the

[3] The attention of the court below was directed to the *Kelley* case, *supra*, in Plaintiff's Request for Findings of Fact and Brief, pp. 101, 102; Plaintiff's Motion for Rehearing and Brief in Support Thereof, pp. 15-21; Reply to Response of the United States to Plaintiff's Motion for Rehearing, pp. 2-4.

royalty to its stockholders, and therefore was merely gratuitous in nature. The entire basis for the court's ignoring the 1942 transaction and disregarding the existence of the petitioner corporation was grounded upon *Gregory* v. *Helvering, supra,* a copy of which is set forth in Appendix D, pp. 40a-43a, and related cases, and the "business purpose" doctrine set forth therein.[4]

These cases stand for the proposition that, although a tax-saving motive is insufficient by itself to disqualify a reorganization for tax purposes, nevertheless, a reorganization which involves a transitory or ephemeral corporation and which lacks "business purpose" will not be regarded as falling within the statutory definition of "reorganization", as contained in section 112 (g)(1) of the 1939 Code. Accordingly, two matters are to be emphasized: (1) these cases concerned transactions involving transitory or ephemeral corporations and (2) the question at issue was merely whether or not a statutory reorganization was involved—i.e., whether certain transfers of property were taxable or tax free. Neither factor is present in the instant case.[5]

In *Gregory* v. *Helvering, supra,* this Honorable Court held that no tax-free reorganization occurred

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[4] *Minnesota Tea Company* v. *Helvering,* 302 U.S. 609 (1938); *Griffiths* v. *Commissioner of Internal Revenue,* 308 U.S. 355 (1940); *Helvering* v. *Alabama Asphaltic Limestone Company,* 315 U.S. 179 (1942); *Bazley* v. *Commissioner of Internal Revenue,* 331 U.S. 737 (1947).

[5] The case of *Higgins* v. *Smith,* 308 U.S. 473 (1940), also relied upon by the lower court, did not involve the question whether a statutory reorganization was present. This case merely looked to whether a sale between a corporation and its *sole* stockholder was an open or closed transaction for tax purposes. It is clearly distinguishable from the instant case.

where a corporation had been formed merely for the purpose of obtaining tax benefits and liquidated three days thereafter.[6] In so doing, the Supreme Court of the United States stated beginning on page 469:

> "* * * Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? *Simply an operation having no business or corporate purpose*—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. *No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been excercised, it immediately was put to death.*" [Emphasis added.]

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[6] In that case the taxpayer owned all of the stock of corporation A, which owned 1000 shares of stock in corporation B. In order for the taxpayer to obtain possession of these shares, a new corporation C was organized to which corporation A transferred the 1000 shares of stock of corporation B. All of the stock of the new corporation—C—was transferred to the taxpayer directly. Three days later the new corporation was dissolved and the 1000 shares of corporation B stock, being all of corporation C's assets, were distributed to the taxpayer who sold them immediately and reported the profit as a capital gain. The Supreme Court of the United States held that there was no statutory reorganization and held that the taxpayer was liable as recipient of a dividend of the 1000 shares of corporation B stock.

In the *Gregory* case, *supra,* there was an ephemeral corporation formed merely for the purpose of obtaining tax benefits and liquidated three days after its creation.[7] However, applying the doctrine of *Gregory* v. *Helvering, supra,* and related cases, to those situations involving transitory transactions is one thing; but it is another thing to apply it to a situation as in the instant case where the transaction was not transitory but rather resulted in the creation of a permanent operating corporation. Also, it is another thing to apply the test to the determination of the validity of corporate obligations rather than merely to the determination whether or not a statutory reorganization existed. With the exception of the decision of the United States Court of Claims in the instant case, the doctrine set forth in *Gregory* v. *Helvering, supra,* and related cases, has never been applied so as to disregard a permanent and functioning corporation. In fact, petitioner submits that it has been decided on many occasions that credence must be given to a reorganization creating a corporation which is both functioning and permanent—irrespective of the purpose for causing the reorganization.[8]

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[7] *Kelley* v. *Commissioner of Internal Revenue, supra; Survaunt* v. *Commissioner of Internal Revenue,* 162 F. 2d 753 (CA-8, 1947); *Lewis* v. *Commissioner of Internal Revenue,* 160 F. 2d 839 (CA-1, 1947); and *Lea* v. *Commissioner of Internal Revenue,* 96 F. 2d 55 (CA-2, 1938).

[8] Where the organization of the new corporation is not a sham in that a permanent functioning corporation is formed, credence is given to the organization of that new corporation. See *Electrical Securities Corporation* v. *Commissioner of Internal Revenue,* 92 F. 2d 593 (CA-2, 1937); *Chisholm* v. *Commissioner of Internal Revenue,* 79 F. 2d 14 (CA-2, 1935), *cert. den.,* 296 U.S. 641 (1935); *Survaunt* v. *Commissioner of Internal Revenue, supra,* and *Lewis* v. *Commissioner of Internal Revenue,* 176 F. 2d 646 (CA-1, 1949).

It is clear that the lower court's reliance upon *Gregory* v. *Helvering, supra,* and the related cases cited in footnote 4, *supra,* resulted in a misconstruction and a misapplication of some of the leading decisions rendered by this Court in the field of taxation. This Honorable Court limited the doctrine of the *Gregory* case, *supra,* to transactions involving temporary compliance with statutory literalness when it stated in the *Kelley* case, *supra,* on page 525 as follows:

> "There is not present in either situation *the wholly useless temporary compliance with statutory literalness* which this Court condemned as futile, as a matter of law, in Gregory v. Helvering, 293 U.S. 465. *The demonstrated possibility of sales by the holders of the obligations to persons other than stockholders alone proves the differentiation.* * * *" [Emphasis added.]

No such temporary compliance exists in the instant case.

In yet another way the majority of the Court of Claims has grossly misapplied the "business purpose" doctrine as developed by this Honorable Court in *Gregory* v. *Helvering, supra; John Kelley Company* v. *Commissioner, supra; United States* v. *Cumberland Public Sales Co.,* 338 U.S. 451 (1950), and related cases. This misapplication rests in the view of the majority that certain obligations of the petitioner corporation, otherwise concededly valid, did not qualify as deductible royalty payments *only* because the reorganization giving them birth was motivated solely by the stockholders' desire to save Federal taxes. The "business purpose" test as applied to a valid, perma-

nent corporation has never been grounded solely on the touchstone of taxpayer motive and it is not so grounded today.

Nobody, certainly not petitioner, denies the eminently proper function of a court to look through the form of a transaction to determine if the transaction under scrutiny is in reality what it appears to be. The bona fides of the royalty payments here in dispute are a fitting subject for the most searching scrutiny by any court. However, under the very authorities cited by the Court of Claims, it is the court's obligation to determine the factual nature of the royalty payments for the years in question, and the legal consequences thereof, without *sole* reference to consideration of "motive" in the formation of the petitioner and the creation of the overriding royalty contract. On a factual level of inquiry, "motive" is most significant in determining what *in fact* took place; but once the content of a transaction is determined, motive is immaterial in determining the legal consequences which attach to that content. Reality—not wish nor desire nor motivation—governs the tax consequences of a transaction.[9]

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[9] The distinction here described is best grasped by comparing *Court Holding Company* v. *Commissioner of Internal Revenue*, 324 U.S. 331 (1945), with *United States* v. *Cumberland Public Service Co., supra.* These cases involved the question whether sales in liquidation made by shareholders of property previously distributed to them in kind were actually made by the corporation (if so, the corporate tax would have been imposed). In *Court Holding Company, supra,* a sale by the stockholders was found to have been actually made by the corporation, even though it had distributed the property prior to the completion of the formalities of sale. In *Cumberland, supra,* the sale was found not to have been made by the corporation under a somewhat similar set of facts. The motives of the shareholders in making the distribution

Thus, in the case at bar, motive with respect to the 1942 reorganization is irrelevant in determining the nature of the royalty payments. If this is so, the payments are concededly deductible. Under the 1942 reorganization, the corporation *was* reorganized; the old corporation did *not* survive; new, permanent relationships between the stockholders and the stockholders and the petitioner, were created; new and enduring obligations *did* come into effect under the terms of which petitioner *had* had to make payments of an additional five cents a ton in order to mine coal from the Ditney Hill Mine. To disregard the permanent operating corporation created in such a substantial transaction is clearly contrary to the law on the subject as set down by this Honorable Court.

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prior to sale were identical in both cases, namely, *avoidance of the corporate tax on sale of the property*. But in one case the tax was imposed because the sale was found to have been made by the shareholders as agents of the corporation; in the other, tax was avoided because the shareholders were found to have made the sale on their own behalf. The reality of the transaction was unimpaired by the sole motive of escaping a tax on the corporations. In the *Cumberland* case, *supra*, the Supreme Court of the United States stated, on page 455:

> "• • • The Government's argument that the shareholders acted as a mere 'conduit' for a sale by respondent corporation must fall before this finding. *The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.*" (Emphasis added.)

Indeed, "Purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation. • • •" *Lea* v. *Commissioner of Internal Revenue, supra*, at p. 57.

3. Certainly, the question presented in the instant case is of great importance in the administration of the tax laws and in the public interest. If this decision stands, the Commissioner of Internal Revenue is free to roam at will throughout myriad corporate activities and, with no more than this distorted version of the "business purpose" doctrine in hand, to strike down permanent and valid corporate transactions for no other reason than that they were entered into for tax-saving motives.

In the complex field of Federal income taxation, where concept and abstraction obscure in ever-shifting patterns the reality that lies beneath, it is altogether too easy for a court to strike down an operating corporation solely because of the apparently ignoble tax-saving motives of its shareholders (for whose personal benefit, in the last analysis, the corporate structure is always employed). But this is the very thing which this Court has said in the *Kelley* and *Cumberland* cases, *supra,* may not be done by any tribunal; and, wisely so, for the power of a court to say that what appears to be is not actually so is a terrible weapon—one that should be used with great self-restraint in conformity with authority and precedent. To repeat: Is the transaction under scrutiny in reality what it appears to be in form? If so, a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it.

CONCLUSION

For the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX

APPENDIX A

IN THE UNITED STATES COURT OF CLAIMS

No. 50326

(Decided January 11, 1955)

INGLE COAL CORPORATION v. THE UNITED STATES

• • • • • • • • • • •

LITTLETON, *Judge*, delivered the opinion of the court:

The plaintiff, a corporation, sues for $32,289.85, with interest thereon, which represents alleged overpayments of Federal income taxes for 1947 and 1948. The issue presented is whether certain "over-riding royalties" paid by plaintiff in 1947 and 1948 are deductible as ordinary and necessary expenses under section 23 (a) (1) (A) of the Internal Revenue Code, (26 U.S.C. Sec. 23 (a)). The facts have been stipulated and those material may be summarized as follows: The Ingle Coal Company, plaintiff's predecessor, (hereinafter sometimes referred to as the old corporation) was a family corporation. All its stock was held by members of the Ingle family consisting of two brothers, two sisters, and the children of the brothers. The old corporation was engaged in the business of mining bituminous coal on lands held under a lease (not acquired from the Ingle family) beginning on June 1, 1940. A royalty of five cents a ton was being paid the lessor under the lease. The business had appreciated considerably in value and in the spring of 1942, an offer of $1,000,000 was made to the old corporation for its assets. The offer was rejected. The stockholders of plaintiff's predecessor decided to liquidate the corporation, transfer its assets and liabilities to the stockholders who would then transfer them to a new corporation to be organized in exchange for the stock of the new corporation and a contract obligating the new corporation to pay named individuals, who were then the stock-

holders, five cents a ton royalty, in addition to the royalty stipulated in the lease, on the coal thereafter mined under the above lease.

This plan was adopted and consummated for the purpose of reducing taxes, assuring a more definite income to Katherine I. Mitchell and Frances I. Bebb, two of the stockholders, and allowing the disposition of the stock, for a lesser price, and still retaining an interest in the coal business.

A stockholders' meeting of the old corporation was held on June 30, 1942, and a resolution was adopted that the corporation discontinue business and that its assets and liabilities be distributed to the stockholders, or their nominee, in proportion to their respective stock holdings. The president and secretary were authorized and directed to make all necessary transfers, conveyances and assignments. The stockholders agreed to accept the proposed distribution, and individually authorized the transfer and conveyance of the assets and liabilities to the plaintiff as their nominee. On the same day the directors of the plaintiff met, and after organizing and electing officers, received and accepted a proposal by the stockholders of the old corporation to convey the assets that had been distributed to their nominee, the plaintiff, to plaintiff in consideration of the assumption by the plaintiff of the liabilities assumed by them in the liquidation of the predecessor corporation; the issuance of the plaintiff's stock in the same proportion as they had held stock in the old corporation, and also a separate agreement by the new corporation to pay them in proportion to their stock holdings in the old corporation a royalty of five cents a ton on the coal mined under the lease. Four of the stockholders also agreed to subscribe to 500 additional shares of the plaintiff's stock. The necessary legal documents for carrying out the above plan were duly executed.

The plaintiff paid the named individuals in the contract, who had been the stockholders of the old corporation and

were then plaintiff's stockholders, five cents a ton royalty on the coal mined under the lease (hereinafter referred to as over-riding royalties), in addition to the five cents a ton paid to the original lessor, and claimed a deduction therefor under section 23 (a) (1) (A) for the period from July 1, 1942, to December 31, 1942, and for the year 1943. The Commissioner of Internal Revenue allowed the royalties paid to the original lessor but disallowed the over-riding royalties. The Tax Court in *Ingle Coal Corporation* v. *Commissioner*, 10 T.C. 1199, held that the over-riding royalties paid to the stockholders under the agreement were not an ordinary and necessary expense and were in substance a nondeductible dividend distribution. The United States Court of Appeals for the Seventh Circuit in *Ingle Coal Corporation* v. *Commissioner*, 174 F. 2d 569, affirmed the Tax Court on the same ground.

Katherine I. Mitchell, recipient of 25 percent of the over-riding royalties, died on May 5, 1943. Her stock was sold to other stockholders of the plaintiff and her rights to the over-riding royalties were distributed to her heirs and legatees. On June 28, 1944, Frances I. Bebb, recipient of 25 percent of the over-riding royalties, donated to each of her six nephews and one niece 25 shares of her stock. The gifts upset the equality of the holdings by the David Ingle and William D. Ingle branches of the family. On April 1, 1946, the remainder of her stock was sold and the equality of holdings of the two families was again attained. She retained the over-riding royalty rights.

The over-riding royalties have been paid continuously each year since July 1, 1942. In addition to such payments dividends were paid in 1947 and 1948 in the amounts of $65,000 and $115,000, respectively.

On its Federal tax returns for the years 1947 and 1948 the plaintiff claimed, *inter alia*, deductions for the over-riding royalties in the amounts of $42,761.10 and $34,223.70, respectively. The Commissioner disallowed the deduction

and assessed an additional tax, which was paid. A timely claim for refund was filed and after six months had expired without the Commissioner's formal rejection this action was instituted.

The defendant contends that plaintiff cannot litigate the present claim because it is estopped by the collateral estoppel branch of the rule of *res judicata* for the reason that the material facts and the issues of law presented in the present case are the same as those previously litigated in *Ingle Coal Corporation* v. *Commissioner*, 174 F. 2d 569. Plaintiff asserts that the material facts and the issues of law raised in the instant proceeding are not the same. Both parties cite and rely on *Commissioner* v. *Sunnen*, 333 U. S. 591.

The taxpayer in the *Sunnen* case, *supra*, had granted to a corporation in which he owned 89 percent of the stock, a non-exclusive license to manufacture and sell certain devices, covered by patents that he owned, in exchange for specified royalties. At various times he assigned these royalty contracts, which were identical in all important respects, to his wife. The tax question raised by the license contracts was whether the income accruing under them should be taxed to the husband or to his wife. The Board of Tax Appeals held that the income earned on one of these contracts was not taxable to the husband. In subsequent years, after the *Clifford-Horst* line of decisions[1] on assignment of income, the Commissioner again taxed the income earned under the contracts to the husband. The Supreme Court, in drastically limiting the doctrine in tax cases, held that collateral estoppel did not preclude the income from the identical contract from being taxable to the husband because of a legal doctrinal change. The Court, in the *Sunnen* case, *supra*, in holding that collateral

[1] *Helvering* v. *Clifford*, 309 U. S. 331; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Eubank*, 311 U. S. 122; *Harrison* v. *Schaffner*, 312 U. S. 579; *Commissioner* v. *Tower*, 327 U. S. 280; and *Lusthaus* v. *Commissioner*, 327 U. S. 293.

estoppel did not preclude the income from the similar contracts from being taxed to the husband, stated:

> • • • But a subsequent modification of the significant facts or a change or development in the controlling legal principles may make that determination obsolete or erroneous, at least for future purposes. • • •
>
> • • • It [collateral estoppel] must be confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged. • • •
>
> • • • But if the relevant facts in the two cases are separable, even though they be similar or identical, collateral estoppel does not govern the legal issues which recur in the second case. Thus the second proceeding may involve an instrument or transaction identical with, but in a form separable from, the one dealt with in the first proceeding. In that situation, a court is free in the second proceeding to make an independent examination of the legal matters at issue. It may then reach a different result or, if consistency in decision is considered just and desirable, reliance may be placed upon the ordinary rule of *stare decisis*. Before a party can invoke the collateral estoppel doctrine in these circumstances, the legal matter raised in the second proceeding must involve the same set of events or documents and the same bundle of legal principles that contributed to the rendering of the first judgment. • • •

The fact that 50 percent of the over-riding royalties involved in this case were paid in the taxable years in question to non-stockholders is a significant change in the material facts which entitles the plaintiff to its day in court and the consideration of the entire question in view of the subsequent developments and, therefore, the doctrine of collateral estoppel is inapplicable.

On the merits of the case we have the question of whether the payment of these over-riding royalties were an ordinary

and necessary expense and therefore deductible under section 23 (a) (1) (A)[2] of the Code.

The plaintiff first points out that reasonable rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity, are specifically allowed under section 23 (a) (1) (A) as an ordinary and necessary expense. Plaintiff then contends that these over-riding royalties were required to be paid for the continued use of the mine under an unconditional contract and that they were not dependent upon earnings; that they were paid for purposes of trade or business; that plaintiff did not own the land but only the right to mine it conditioned upon paying a royalty therefor, and since it is conceded that they were reasonable in amount, they should be allowed as a deduction.

The defendant contends that from a business standpoint, the entire transaction was unnecessary, and that the assumption of the contractual obligation by plaintiff was gratuitous; that the transfer by the old corporation to the stockholders was artificial; that they had no discretion other than to transfer the assets to plaintiff pursuant to the plan; that such a transfer was only a step in an integrated plan and therefore was in reality a reorganization and as such the over-riding royalty contract should be treated the same as if plaintiff's predecessor had assumed the obligation of paying the royalties to its stockholders, which it says would clearly be a dividend distribu-

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[2] § 23. "Deductions from gross income. In computing net income there shall be allowed as deductions: (a) Expenses. (1) Trade or business expenses. (A) In general. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for * * * payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. * * * "

tion and not deductible; and further defendant says that to allow plaintiff to deduct these payments would pervert the statutory policy of deductions.

The criterion employed in determining whether a corporation should liquidate, recapitalize or reorganize is not necessity, but rather business prudence and convenience. Taxpayers, of course, are free to adopt any form of legal organization for the conduct of their financial affairs that they desire and may change from one to another, although the change may or may not result in a payment of a tax on the conversion. It is well settled that taxpayers have the legal right to decrease the amount of what otherwise would be their taxes, or altogether avoid them, by means which the law permits. But the means adopted are subject to scrutiny, and, in a proper case, may be ignored for tax purposes. Taxpayers are not required, however, to carry out their transactions in a way that will produce the most tax for the Government. *United States* v. *Isham*, 17 Wall. 496, 506; *Gregory* v. *Helvering*, 293 U. S. 465, 469; *Commissioner* v. *Tower*, 327 U. S. 280; *Chamberlin* v. *Commissioner*, 207 F. 2d 462, 468; *Zenz* v. *Quinlivan*, 213 F. 2d 914, 916; *Coca-Cola Company* v. *United States*, 97 C. Cls. 241, 261, 47 F. Supp. 109. The fact that the plaintiff's predecessor corporation was *voluntarily* liquidated and its assets and liabilities transferred to the stockholders and immediately to the new corporation with the reservation of the over-riding royalties does not necessarily prevent the deduction. *Skemp* v. *Commissioner*, 168 F. 2d 598; *Brown* v. *Commissioner*, 180 F. 2d 926; *Stearns Magnetic Mfg. Co.* v. *Commissioner*, 208 F. 2d 849; *Felix* v. *Commissioner*, 21 T. C. 794, and the cases above cited. Also, the fact that plaintiff was a family corporation does not mean that its stockholders were disqualified or precluded from contracting with it as long as the arrangement was fair and reasonable judged by standards of a transaction entered into by parties dealing at arm's length, and where in substance and in fact the stockholders had something to

give in return for what they received. Not only do the cases support this statement but the Commissioner has so ruled. O. D. 440 C. B. Jan.-June 1920, 215; *A. & A. Tool & Supply Co.* v. *Commissioner*, 182 F. 2d 300; *J. H. Robinson Truck Lines* v. *Commissioner*, 183 F. 2d 739; *Commissioner* v. *Thomas Flexible Coupling Co.*, 14 T. C. 802, aff'd 198 F. 2d 350; *Stearns Magnetic Mfg. Co.* v. *Commissioner, supra*, at p. 852; *Differential Steel Car Co.* v. *Commissioner*, 16 T. C. 413.

It is also well settled, however, that for the purpose of the proper administration of the taxing statutes, transactions between close or family corporations and its stockholders are subject to special scrutiny to determine their true purpose and effect; that transitory phases of an arrangement that add nothing of substance to the completed affair should be disregarded for tax purposes, and that substance and reality should prevail over form and sham. *Gregory* v. *Helvering, supra; Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S. 473; *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U. S. 179; *Bazley* v. *Commissioner*, 331 U. S. 737.

Viewing the facts of this case in the light of these precepts we conclude that the transaction involved in this case was without substance and was a sham. Although it falls within the literal language of the applicable sections of the Code the recognition of the transaction for tax purposes would, in our opinion, exalt artificiality over reality. The transaction had no genuine business purpose. The old corporation owned the lease and had the right to mine the coal thereunder, and the circulatory transaction, motivated by personal reasons, was simply an empty device designed to convert nondeductible dividends into deductible royalty payments. When we view this transfer in the light of all the facts and circumstances we find it to have been absolutely without substance, and we believe that the defendant correctly asserts that the over-riding royalty

contracts should be treated the same as if the plaintiff's predecessor corporation had assumed the obligation of paying the royalties to its stockholders. As such the agreement lacked real consideration, was gratuitous, and was in reality an arrangement for a distribution of dividends or profits in the guise of royalty payments. *Gregory* v. *Helvering, supra; Minnesota Tea Co.* v. *Helvering, supra; Griffiths* v. *Commissioner, supra; Higgins* v. *Smith, supra; Helvering* v. *Alabama Asphaltic Limestone Co., supra; Bazley* v. *Commissioner, supra;* and *Ingle Coal Corporation* v. *Commissioner, supra.* The fact that 50 percent of the so-called over-riding royalty payments were made in 1943, 1944, 1946 and thereafter, to members of the general family who were not stockholders does not in the circumstances require the allowance of a deduction therefor by plaintiff as an ordinary and necessary expense. Since we have ignored the entire transaction and considered the plaintiff to be in reality the same as its predecessor, and therefore consider the assumption of the obligation to pay the over-riding royalties as gratuitous for tax purposes, the payment of the over-riding royalties were not then and are not now an ordinary and necessary expense within the meaning of the taxing statutes and are not deductible under section 23 (a) (1) (A) of the Code. *Cf. Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590; *Friedman* v. *Delaney,* 171 F. 2d 269.

The plaintiff is not entitled to recover and its petition is dismissed.

It is so ordered.

LARAMORE, *Judge;* and JONES, *Chief Judge,* concur.

MADDEN, *Judge,* dissenting.

The stockholders, through their interest in the predecessor corporation, owned, in addition to a profitable going business, a valuable asset. That asset was a coal lease at five cents a ton royalty. The coal property was apparently

such that an operator could have afforded to pay a much higher royalty and still have made a profit. If the owners of the predecessor corporation had decided to liquidate it, and take individual ownership of the lease, and sublease it to another operator, that operator's royalty payments would, of course, have been deductible as rents. Here the owners elected to do that, but they themselves formed the new corporation. However, they changed substantially the legal relations which they had had with the former corporation. Their right to the rents, or over-riding royalties, they retained as individuals. To be sure, their interest in these royalties was in proportion to their ownership of the stock of the respective corporations, but that would have been true if the sublease had been to a stranger operator. That was the proportion in which they owned the old corporation and its assets, including the lease.

Their rights as individuals to the over-riding royalties were not tied to their stockholdings in the new corporation. There was no covenant that they must be transferred together. Within a comparatively short time after the arrangement was made, 50 percent of the stock of the new corporation passed, by normal devolution, to persons other than the owners of the over-riding royalties.

I think that royalty payments not in fact made to stockholders, or made to stockholders not as such but only because they happen to continue to own the right to the royalty payments, are not the substantial equivalent of dividends. If the separation, which was 50 percent complete in the tax years in question, later became 100 percent complete, and the only payments which the corporation could afford to make were the royalty payments to non-stockholders, it would be hard indeed to regard the payments as dividends.

Parties may put a transaction through two steps instead of one for the sole purpose of making it non-taxable, or less taxable, although, apart from the tax question, the form which they give the transaction would be a waste of

time and paper and ink. *United States* v. *Cumberland Public Service Co.*, 338 U. S. 451, affirming 113 C. Cls. 460.

In the instant case, the arrangement adopted had, as is said in the opinion of the court the purpose of assuring a more definite income to some of the then principal stockholders, in addition to the purpose of reducing taxes. The arrangement also made permanent and important changes in the relations to the corporation of the persons who were, as individuals, to receive the royalty payments. The company became unconditionally liable to make these payments, whether it made money on its mining operations or not, and whether the persons owning the royalty rights were stockholders or not.

The transaction was, I think, much more than the sham which it is called in the opinion of the court. I would allow the plaintiff to recover.

WHITAKER, *Judge,* concurs in the foregoing dissent.

FINDINGS OF FACT

The court having considered the evidence, the facts as stipulated by the parties, the briefs and the argument of counsel, makes the following findings of fact:

1. Ingle Coal Corporation, plaintiff herein, is a corporation duly organized under and existing by virtue of the laws of the State of Indiana. It was organized on June 30, 1942, for the purpose of engaging in the business of mining bituminous coal, and its principal office is located at Elberfeld, Indiana. Its authorized capital stock consisted of 3,000 shares, all common, with a par value of $100 each. The returns for the years here involved were filed with the Collector of Internal Revenue for the District of Indiana.

2. Ingle Coal Company, plaintiff's predecessor, was a corporation organized under the laws of the State of Indiana in September 1928. Its capital stock consisted of 2,000 shares which, at all times, was closely held in equal

proportions by the families of the four children of David Ingle, Sr. Its capital stock on June 30, 1942, was held by the following—

Stockholder	*Shares owned*
Frances I. Bebb	500
Katherine I. Mitchell	500
David Ingle	300
David Ingle, Jr.	100
Thomas H. Ingle	100
William D. Ingle	250
William D. Ingle, Jr.	50
Kenneth R. Ingle	50
Jane Ingle Fleig	50
Bradford B. Ingle	50
Donald B. Ingle	50
Total	2,000

Frances I. Bebb and Katherine I. Mitchell were the daughters of David Ingle, Sr.; William D. Ingle and David Ingle were his sons. David Ingle, Jr., and Thomas H. Ingle were sons of David Ingle. William D. Ingle, Jr., Kenneth R. Ingle, Jane Ingle Fleig, Bradford B. Ingle, and Donald B. Ingle were the children of William D. Ingle.

3. Ingle Coal Company, plaintiff's predecessor, was engaged in the business of mining bituminous coal on lands held under lease. The coal lands originally held under lease by said company were worked out by 1940. On June 11, 1940, a lease on certain coal lands located near Elberfeld, Indiana, was executed by James R. Wasson and Charlotte E. Wasson, as lessors, and the Ingle Coal Company, as lessee, which lease was supplemented by an agreement executed by the Ingle Coal Corporation and dated August 8, 1942. A copy of the original lease is marked Exhibit 1 and by this reference made a part hereof. The supplemental agreement made available additional mining lands which the lessors had acquired after the date of the original lease. The coal lands covered by this lease and

supplement thereto will be hereinafter referred to as the Wasson lease.

4. During the year 1940, modern mechanized equipment was installed by Ingle Coal Company, the lessee, in the Ditney Hill Mine on the Wasson lands, and coal was produced therefrom as follows:

By Ingle Coal Company:	*Tons*
1940	31,028
1941	419,824
1942 (First 6 months)	322,421
By Ingle Coal Corporation:	
1942 (Last 6 months)	383,705
1943	751,692
1944	933,719
1945	818,531
1946	711,091
1947	855,222
1948	684,474

5. The gross sales of Ingle Coal Company in 1940, 1941, and the six months ended June 30, 1942, were $77,795.17, $588,011.56 and $474,145.22, respectively. The company paid royalties during said years under the lease executed on June 11, 1940, in the amounts of $1,551.40, $20,991.22 and $16,121.05, respectively.

6. In the spring of 1942, the Binkley Coal Company of Chicago, Illinois, made an offer of $1,000,000 for the assets of Ingle Coal Company. This offer was rejected, one of the reasons being the substantial amount of Federal income taxes which would result with respect to both the company and the stockholders individually if the properties were sold.

7. David Ingle, the president of the Ingle Coal Company, was at all times the dominant personality in its affairs and those of plaintiff and was aware that if addi-

tional royalty deductions claimed in the return were allowed the corporate tax would be reduced.

8. After consultation with their attorney in the spring of 1942, the stockholders of Ingle Coal Company evolved and decided to adopt a plan which included the formation of a new company to be known as Ingle Coal Corporation. The plan contemplated that the Ingle Coal Company distribute all its assets to its stockholders, which they in turn would transfer to the Ingle Coal Corporation on June 30, 1942. For such assets the Ingle Coal Corporation would issue its stock to the same stockholders in the same proportion in which they held stock in the Ingle Coal Company. In addition, it would assume the liabilities of the Ingle Coal Company and would agree to pay to the eleven named stockholders a further "royalty" of 5¢ a ton. It was also agreed that the four stockholders—Frances I. Bebb, Katherine I. Mitchell, David Ingle, and William D. Ingle—would subscribe to 500 additional shares of the capital stock of the Ingle Coal Corporation to be paid for as hereinafter set forth.

9. On June 25, 1942, the directors of the Ingle Coal Company held a meeting for the purpose of consenting to the formation of the new corporation. A copy of the minutes of that meeting is marked Exhibit 1A and by this reference made a part hereof.

10. On June 30, 1942, the stockholders of the Ingle Coal Company held a meeting, all stockholders being present in person or by proxy, for the consideration of the proposal referred to in finding 8. The following resolution was adopted:

> BE IT RESOLVED, That Ingle Coal Company, a corporation organized in 1928 under the laws of the State of Indiana, discontinue business and that all its property and assets of every sort and description be distributed to its stockholders, or to their nominee or nominees, effective at the close of business on June 30, 1942, in proportion to the respective holdings

by such stockholders of the capital stock in said corporation, and subject to the obligation of such stockholders, their nominee or nominees, to pay and discharge all debts and discharge and carry out all obligations of said corporation of every sort and description, whether now accrued or later to accrue, and on such basis that all such property and assets be so distributed and that such distribution thereof be accepted by said stockholders at the value of such property and assets at the close of business on June 30, 1942 and in full and complete cancellation and redemption of all of the capital stock of said corporation; and

BE IT FURTHER RESOLVED, That the President and Secretary of said corporation be and they are hereby authorized and directed to make such distribution by making all necessary and proper transfers, conveyances and assignments of all property and assets of every sort, real and personal, tangible and intangible, belonging to said corporation, effective at the close of business on June 30, 1942, direct to the owners of the capital stock of said corporation or to such nominee or nominees as such stockholders may designate, and that such transfers, conveyances and assignments of such property and assets be so made and accepted at the value thereof at the close of business on June 30, 1942, and be so made and accepted subject to the obligation of the party or parties to whom such property and assets are transferred to pay and discharge all debts and discharge and carry out all obligations of said corporation, of every sort and description, and on such basis that such distribution be made and accepted in full and complete cancellation and redemption of all the outstanding capital stock of said corporation.

Following the adoption of the above resolution, the minutes stated:

Each of the stockholders of the corporation, either in person or by their duly authorized representatives and proxies present at the meeting who held powers of attorney authorizing them to act for such absent

stockholders on all matters, agreed to accept the proposed distribution of all of the property and assets of the corporation on the basis and subject to the provisions of said resolution, and agreed that they would forthwith surrender their capital stock in the corporation as cancelled and redeemed upon such distribution being made to their nominee hereinafter named, and further agreed to sign the minutes of this meeting to evidence such consent and agreement on their part.

And each of the stockholders of the corporation acting as aforesaid, authorized and directed that all of the real and personal property and all assets of the corporation of every sort and description be distributed as contemplated by the said resolution just passed, and be transferred and conveyed into Ingle Coal Corporation, which is a new corporation organized in June 1942 under the General Corporation Act of the State of Indiana, which said Ingle Coal Corporation was named as the nominee of each and all of said stockholders.

There being no further business, the meeting adjourned.

A copy of the minutes of this meeting is marked Exhibit 2 and by this reference made a part hereof.

11. On June 30, 1942, pursuant to the foregoing, the existence of the Ingle Coal Company was terminated and its assets were transferred to and its liabilities were assumed by its stockholders, in accordance with the provisions of Exhibit 2 which is partially set forth in finding 10.

12. Thirty minutes after the meeting of stockholders of Ingle Coal Company on June 30, 1942, the identical persons held a meeting for the purpose of organizing the Ingle Coal Corporation, plaintiff herein. After organization and election of officers the following proposal was considered:

The undersigned, who are the holders and owners of all of the outstanding 2,000 shares of capital stock of

Ingle Coal Company, an Indiana corporation, having designated Ingle Coal Corporation, a corporation organized in June 1942 under the laws of the State of Indiana, as the nominee of the undersigned, to which will be transferred and conveyed all of the real estate and personal property and assets of every sort and description owned by said Ingle Coal Company, effective at the close of business on the 30th day of June 1942 on such basis that such transfer and conveyance of such assets of said Ingle Coal Company shall constitute distribution of all its assets to its undersigned stockholders and shall be made and accepted in full and complete liquidation of all of the outstanding capital stock of said corporation and shall be subject to the obligation to pay and discharge all debts and obligations of said Ingle Coal Company, all pursuant to a resolution duly passed by the stockholders of said Ingle Coal Company on the afternoon of June 30, 1942, hereby

PROPOSE AND OFFER

to said Ingle Coal Corporation that the undersigned will cause all such real and personal property and assets of said Ingle Coal Company to be so transferred to Ingle Coal Corporation, effective at the close of business on June 30, 1942, and that in consideration thereof said Ingle Coal Corporation shall assume and agree to pay and discharge all debts and obligations of Ingle Coal Company assumed by the undersigned stockholders in the liquidation of Ingle Coal Company for the account of the stockholders; and that Ingle Coal Corporation shall, in consideration of such transfer and conveyance, issue to the undersigned 2,000 shares of the total 3,000 shares of the capital stock of said Ingle Coal Corporation which said corporation is authorized to issue, such 2,000 shares of stock to be issued to the undersigned in the following amounts respectively:

	Shares
Frances I. Bebb	500
Katherine I. Mitchell	500
David Ingle	300
David Ingle, Jr.	100
Thomas H. Ingle	100
William D. Ingle	250
William D. Ingle, Jr.	50
Kenneth R. Ingle	50
Jane Ingle Fleig	50
Bradford B. Ingle	50
Donald B. Ingle	50

and that the property and assets of said Ingle Coal company so to be transferred to said Ingle Coal Corporation shall be transferred at the value thereof at the time said transfer becomes effective at the close of business on June 30, 1942, and that the difference between the actual value of the property and assets so transferred and so received by Ingle Coal Corporation and the par value of the 2,000 shares of capital stock of Ingle Coal Corporation issued therefor, which par value will amount to the sum of $200,000, will be credited by Ingle Coal Corporation to the account of the stockholders of Ingle Coal Corporation, and such credit less any liabilities paid for the stockholders of Ingle Coal Corporation, will be paid in cash or notes or constitute paid-in surplus of Ingle Coal Corporation, or otherwise, as may be directed by the officers of Ingle Coal Corporation; and that, in further consideration of said transfer and conveyance of said assets of Ingle Coal Company to said Ingle Coal Corporation, there shall be executed by Ingle Coal Corporation a separate agreement by which Ingle Coal Corporation shall assume all obligations and duties which were assumed by Ingle Coal Company in the coal lease dated June 11, 1940, executed by James R. Wasson and Charlotte E. Wasson, as lessors, and by said Ingle Coal Company, as lessee, which lease was duly recorded in the office of the Recorder of Warrick County, Indiana in Miscellaneous Record 25 at pages 13 to 19, inclusive, and by which Ingle Coal Corporation shall agree to pay,

as additional compensation and royalty for coal mined by said Ingle Coal Corporation under said lease the sum of five cents per ton for all coal hereafter mined by Ingle Coal Corporation under said lease, which additional compensation and royalty of five cents per ton shall be paid to the undersigned stockholders on the 25th day of each month for coal mined during the previous calendar month, which payment shall be made to the undersigned stockholders in the following proportions, namely:

	Percent
Frances I. Bebb	25
Katherine I. Mitchell	25
David Ingle	17
David Ingle, Jr.	4
Thomas H. Ingle	4
William D. Ingle	15
William D. Ingle, Jr.	2
Kenneth R. Ingle	2
Jane Ingle Fleig	2
Bradford B. Ingle	2
Donald B. Ingle	2

And the undersigned, Frances I. Bebb, Katherine I. Mitchell, David Ingle, and William D. Ingle, further and separately propose to said Ingle Coal Corporation that each of them will purchase 125 shares of the authorized capital stock of said Ingle Coal Corporation at par for the sum of Twelve Thousand Five Hundred Dollars ($12,500.00) each, and will each pay therefor by crediting as paid on the principal of the notes payable to each of them respectivley, each of which notes is for the principal sum of $68,115.20, and which notes were dated April 1, 1942 and executed by Ingle Coal Company, and are to be assumed by said Ingle Coal Corporation, the sum of Twelve Thousand Five Hunddred Dollars ($12,500.00), which amount shall be credited on each of said four notes by endorsement on the back thereof after they have been assumed by said Ingle Coal Corporation, so that the principal sum which will remain unpaid on each of said notes after such credit thereon has been made will be $55,615.20.

> The proposals herein contained are made this 30th day of June, 1942 by the undersigned, subject to acceptance by said Ingle Coal Corporation by endorsement of acceptance on the form provided below, upon such proposals being accepted by vote of the stockholders or directors of said Ingle Coal Corporation.
>
> Signed in Evansville, Indiana, this 30th day of June, 1942.

Pursuant to a lengthy resolution the following acceptance was made:

> The undersigned, Ingle Coal Corporation, hereby accepts each of the proposals contained in the foregoing instrument and assents to and agrees to be bound by the terms and provisions thereof and to assume and carry out the obligations and duties by it to be assumed and carried out as provided in the foregoing instrument, and to issue fully paid and nonassessable shares of its capital stock accordingly. This acceptance is made pursuant to a resolution duly passed at the meeting of the Board of Directors of Ingle Coal Corporation held in Evansville, Indiana, this 30th day of June, 1942.

A copy of the minutes of this meeting is marked Exhibit 3 and by this reference made a part hereof.

13. The proposal for the acquisition of assets by plaintiff was accepted on the same day by plaintiff through its officers and directors, and a resolution was adopted authorizing the issuance of plaintiff's stock to the last stockholders of Ingle Coal Company in identical proportions with their holdings in that company, except for the aggregate 500 shares which were to be subscribed in equal amounts at par by Frances I. Bebb, Katherine I. Mitchell, David Ingle, and William D. Ingle, as shown in finding 8. Plaintiff also adopted a resolution for the acceptance of the properties of Ingle Coal Company and the assumption of its liabilities. Thereupon, plaintiff, by its president and secretary, executed and delivered to each of the stockhold-

ers of Ingle Coal Company a separate agreement reciting plaintiff's promise to make payment to each of the individual stockholders of an additional royalty of 5¢ per ton on all coal mined by plaintiff, such payments to be made in the following stated percentages, beginning on August 25, 1942, and monthly thereafter:

	Percent
Frances I. Bebb	25
Katherine I. Mitchell	25
David Ingle	17
David Ingle, Jr.	4
Thomas H. Ingle	4
William D. Ingle	15
William D. Ingle, Jr.	2
Kenneth R. Ingle	2
Jane Ingle Fleig	2
Bradford B. Ingle	2
Donald B. Ingle	2

A copy of this agreement is marked Exhibit 4 and by this reference made a part hereof.

14. Deeds and conveyances of all the properties of the Ingle Coal Company had been prepared and executed by its officers and were thereupon delivered by them, as officers of the Ingle Coal Company to the officers of the plaintiff, and the president and the secretary of the plaintiff were directed to issue shares of stock of the new corporation as agreed upon. Thereupon, the shares of stock were so issued, including 125 additional shares to each of the four stockholders named in finding 8. The amount of $12,500 was credited on each of the previously issued notes of the Ingle Coal Company, which notes constituted part of the obligations of the old company assumed by the plaintiff.

15. The balance sheet of Ingle Coal Company as of June 30, 1942, is as follows:

INGLE COAL COMPANY

ELBERFELD, INDIANA

BALANCE SHEET JUNE 30, 1942

ASSETS:

Cash and Bank	$124,322.97
Accounts Receivable	34,093.65
Advances to Employees	891.34
Inventory—Coal	2,368.19
U. S. Bonds (Tax Series) & Int.	20,016.12
Stocks	50.00
Plant & Equipment, Less Depreciation	330,936.50
Mine Development, Less Depletion	34,033.28
Wick Coal Land, Less Depletion	1,482.03
Wick Surface Land	1,257.00
Wick Machinery	3,700.92
Prepaid Insurance	2,922.02
Indiana U. C. Tax (1941) Refundable	55.84
Total	$556,129.86

LIABILITIES AND CREDITS:

Accounts payable	$ 16,448.51
Notes Payable	272,460.79
Res. for Taxes, except Income	10,610.77
Accrued Expense	6,414.18
Res. for Fed. Income Taxes	37,665.06
Capital Stock	199,767.48
Surplus and Profits	12,763.07
Total	$556,129.86

The balance sheet of Ingle Coal Corporation as of June 30, 1942, is as follows:

INGLE COAL CORPORATION

ELBERFELD, INDIANA

BALANCE SHEET JUNE 30, 1942

ASSETS:

Cash	$124,322.97
Deposits	48.00
Coal Inventory	2,368.19
Indiana Coal Stock	50.00
Prepaid Items	2,922.02
Wick Mine Assets	6,439.95
Depreciable & Depletable Assets	362,616.96
Total	$498,768.09

LIABILITIES AND CAPITAL:

Notes Payable	$222,460.79
Stockholders Account	26,307.30
Capital Stock	250,000.00
Total	$498,768.09

16. The officers and directors of Ingle Coal Company, plaintiff's predecessor, and of Ingle Coal Corporation, plaintiff herein, on June 30, 1942, were as follows:

Ingle Coal Company	*Ingle Coal Corporation*
David Ingle, president and director	David Ingle, president and director
William D. Ingle, vice president, secretary and director	William D. Ingle, vice president and director
	Kenneth R. Ingle, Secretary
Frances I. Bebb, director	Frances I. Bebb, director
Katherine I. Mitchell, director	Katherine I. Mitchell, director
J. H. Iglehart, director	J. H. Iglehart, director

17. Katherine I. Mitchell died on May 5, 1943.

18. The stock of the plaintiff corporation, owned by the Estate of Katherine I. Mitchell, was sold as follows:

Date	*Purchaser*	*Number of shares*	*Total purchase price*
June 12, 1944.....	David Ingle	112½	$11,250.00
June 12, 1944.....	Thomas H. Ingle	100	10,000.00
June 12, 1944.....	David Ingle, Jr.	100	10,000.00
June 12, 1944.....	William D. Ingle	312½	31,250.00

On June 28, 1944, Frances I. Bebb donated to each of her six nephews and her one niece 25 shares of her original stock in the plaintiff. The gifts upset the equality of the holdings by the David Ingle and William D. Ingle branches of the family. The balance of Frances I. Bebb's stock in the plaintiff corporation was sold on April 1, 1946, at par, as follows: David Ingle—262½ shares, William D. Ingle—187 shares. After the above sales had been made by the Estate of Katherine I. Mitchell and by Frances I. Bebb, the entire stock in the plaintiff corporation was held in equal proportions by the families of David Ingle and William D. Ingle.

19. After the disposition of their stockholdings in the plaintiff corporation, Frances I. Bebb and the heirs or legatees of Katherine I. Mitchell retained their interest in the agreement designated as an "over-riding royalty contract." They still receive payments thereunder.

20. Plaintiff accrued and currently paid the following amounts under the agreements with the Wassons and the Ingle, Bebb and Mitchell interests, the payments being designated in plaintiff's books as royalties:

Year	*To Wassons*	*Ingle, Bebb and Mitchell interests*
From July 1, 1942, to December 31, 1942	$19,185.25	$19,185.25
1943	37,584.60	37,584.60
1944	46,685.95	46,685.95
1945	40,926.55	40,926.55
1946	35,554.55	35,554.55
1947	42,761.10	42,761.10
1948	34,223.70	34,223.70

21. On its federal tax returns for the taxable years 1947 and 1948, plaintiff claimed deductions in the respective amounts of $85,522.20 and $68,447.40, under the designation "royalties." Included in the amounts were the amounts of $42,761.10 and $34,223.70 paid or accrued to James R. and Charlotte E. Wasson, lessors, representing royalty payments at the rate of 5¢ per ton for each ton of coal mined. Also included in the amounts were the amounts of $42,761.10 and $34,223.70, respectively, representing payments computed at the rate of 5¢ per ton, under the contract designated as an over-riding royalty agreement, for each ton of coal mined. These latter payments were made by plaintiff by monthly checks drawn on the City National Bank, Evansville, Indiana, payable to the order of David or Kenneth R. Ingle, agent, for the benefit of the interests other than the Wassons, listed in finding 20. The checks were endorsed either by David Ingle or by Kenneth R. Ingle, and deposited in the account "David or Kenneth R. Ingle, Agent", in the Old National Bank, Evansville, Indiana.

22. Upon an audit of plaintiff's corporation income tax return for the calendar year ended December 31, 1947, the Commissioner of Internal Revenue disallowed as a deduction the amount of $42,761.10 paid as above under the contract designated as an over-riding royalty agreement. As a result, the Commissioner increased the plaintiff's total

tax liability to $284,047.87, upon which an additional tax was timely assessed against plaintiff for 1947 in the amount of $14,740.34. On June 12, 1950, plaintiff paid to the Collector of Internal Revenue for the District of Indiana the additional tax of $14,740.34, plus interest thereon of $1,836.69, a total of $16,577.03.

23. Upon an audit of plaintiff's income tax return for the calendar year 1948, the Commissioner of Internal Revenue disallowed as a deduction the amount of $34,223.70 which plaintiff had paid under the contract designated as an overriding royalty agreement. As a result, the Commissioner increased plaintiff's total tax liability for 1948 to $310,471.08, upon which an additional tax was timely assessed against plaintiff in the amount of $18,558.51. On June 12, 1950, plaintiff paid to the Collector of Internal Revenue for the District of Indiana the additional tax, plus interest thereon in the amount of $1,198.93, a total of $19,757.44.

24. On March 6, 1951, plaintiff duly filed with the Collector of Internal Revenue a claim on Treasury Department Internal Revenue Service Form 843 for the refund of $18,085.91 of the income tax and interest paid for its taxable year ended December 31, 1947. In the claim it was set forth that the claim should be allowed for the following reasons:

> On June 30, 1942, the taxpayer acquired the right to mine coal from the Ditney Hill Mine on condition that it pay to the former stockholders of Ingle Coal Company an overriding royalty of five cents a ton on all coal produced from said mine. The taxpayer executed and delivered to each of the former stockholders of the Ingle Coal Company a separate agreement evidencing its obligation to make payment to each of such individuals his respective proportion of the overriding royalty of five cents a ton. During the taxable year the petitioner mined 855,222 tons of coal from the Ditney Hill Mine and became obligated to and did pay to the parties named the overriding royalty of five cents a ton, a total payment of $42,761.10. The overriding royalty

of $42,761.10 represented an ordinary and necessary expense paid or incurred by the taxpayer during the taxable year in carrying on its trade or business of producing and selling coal and is an allowable deduction for said year under section 23(a) of the Internal Revenue Code.

In support of this claim, the taxpayer shows that the final decision in the case of *Ingle Coal Corporation* v. *Commissioner*, 174 Fed. (2d), 569, involving the years 1942 and 1943, is not res judicata of this claim for the reasons that the facts have materially changed, namely, (a) a different taxable year is involved, and (b) the two largest stockholders, Mrs. Katherine I. Mitchell and Mrs. Frances I. Bebb, owners of one-half of the entire outstanding stock during 1942 and 1943, disposed of all of their stock prior to the beginning of the taxable year here involved, but retained ownership of their overriding royalty contracts.

25. On March 6, 1951, plaintiff duly filed with the Collector of Internal Revenue a claim on Treasury Department Internal Revenue Service Form 843 for the refund of $14,203.94 of the income tax and interest paid for its taxable year ended December 31, 1948. This claim was identical to the claim for 1947, except for the following:

During the taxable year the petitioner mined 684,474 tons of coal from the Ditney Hill Mine and became obligated to and did pay to the parties named the overriding royalty of five cents a ton, a total payment of $34,223.70.

26. Plaintiff's net incomes for the last six months of 1942 and for each of the calendar years to and including 1948, with allowing and without allowing the deductions of the character claimed allowable in this action, were as follows:

Year	Net income with allowing the deduction	Net income without allowing the deduction
1942	$ 76,771.83	$ 95,957.08
1943	195,615.38	233,199.98
1944	293,744.01	340,429.96
1945	193,241.81	234,168.36
1946	36,510.87	72,065.42
1947	709,452.24	752,213.42
1948	788,177.80	822,401.50

27. Plaintiff's earned surplus for the last six months of 1942 and for each of the calendar years to and including 1948, after charging its surplus account with $750,000 in 1947 for a new mine purchased, was as follows:

Year ended December 31,	Earned surplus
1942	$ 56,844.82
1943	209,797.78
1944	258,661.64
1945	359,539.14
1946	447,288.29
1947	185,596.06
1948	675,195.03

28. Plaintiff paid dividends to stockholders for the last six months of 1942 and for each of the calendar years to and including 1948 as follows:

Year	Dividends paid
1942	None
1943	None
1944	$ 3,750.00
1945	18,750.00
1946	15,000.00
1947	65,000.00
1948	115,000.00

29. Plaintiff's claims for refund, filed on March 6, 1951, for the years 1947 and 1948, have not been formally rejected but more than six months had expired after the filing date before this case was instituted on September 20, 1951.

30. Coal was in great demand in 1942, to and through 1945 and there was a steady increase in the price of coal through the war years, beginning in 1940.

31. The liquidation of the Ingle Coal Company, the transfer of its assets and liabilities to its stockholders and their transfer of them to the Ingle Coal Corporation in exchange for its stock and the overriding royalty contract, was made for the purpose of reducing taxes, assuring a more definite income to Katherine I. Mitchell and Frances I. Bebb, two of the stockholders, and allowing the disposition of the stock for a lesser price, while still retaining an interest in the coal business.

CONCLUSION OF LAW

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes that as a matter of law the plaintiff is not entitled to recover, and its petition is therefore dismissed.

APPENDIX B

STATUTE INVOLVED

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.

(1) Trade or business expenses.

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. In the case of any sports program conducted for the benefit of the American National Red Cross, expenses described in section 22 (b) (16) (B) shall be allowable under this subparagraph only to the extent that such expenses exceed the amount excluded from gross income by section 22 (b) (16)."

APPENDIX C

JOHN KELLEY CO. *v.* COMMISSIONER OF INTERNAL REVENUE

NO. 36 CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.*

Argued October 11, 1945.—Decided January 7, 1946.

* * * * * * * * * * *

Opinion of the Court by MR. JUSTICE REED, announced by MR. JUSTICE FRANKFURTER.

These writs of certiorari were granted to examine the deductibility as interest of certain payments which the taxpayer corporations made to holders of their corporate obligations. Although the obligations of the two taxpayers had only one striking difference, the noncumulative in one and the cumulative quality in the other of the payments reserved under the characterization of interest, the Tax Court (formerly the Board of Tax Appeals, 56 Stat. 957; only its present name will be used herein) held that the payments under the former, the *Kelley Company* case, were interest and under the *Talbot Mills* were dividends. The Circuit Court of Appeals reversed the Tax Court in the *Kelley* case and another circuit affirmed the *Talbot Mills* decision.[1] On account of the diversity of approach in the Tax Court and the reviewing courts, we granted certiorari.

In the *Kelley* case, a corporation, all of whose common and preferred stock was owned directly or as trustee by members of a family group, was reorganized by authorizing

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* Together with No. 47, *Talbot Mills* v. *Commissioner of Internal Revenue*, on certiorari to the Circuit Court of Appeals for the First Circuit.

[1] 1 T. C. 457; 146 F. 2d 466; cert. granted, 325 U. S. 843; Judicial Code § 240 (a). 3 T. C. 95; 146 F. 2d 809; cert. granted, 325 U. S. 844; Judicial Code § 240 (a).

the issue of $250,000 income debenture bearer bonds, issued under a trust indenture, calling for 8% interest, noncumulative. They were offered only to shareholders of the taxpayer but were assignable. The debentures were payable in twenty years, December 31, 1956, with payment of general interest conditioned upon the sufficiency of the net income to meet the obligation. The debenture holders had priority of payment over stockholders but were subordinated to all other creditors. The debentures were redeemable at the taxpayer's option and carried the usual acceleration provisions for specific defaults. The debenture holders had no right to participate in management. Other changes not material here were made in the corporate structure. Debentures were issued to the amount of $150,000 face value. The greater part, $114,648, was issued in exchange for the original preferred, with six per cent cumulative guaranteed dividends, at its retirement price and the balance sold to stockholders at par, which was eventually paid with sums obtained by the purchasers from common stock dividends. Common stock was owned in the same proportions by the same stockholders before and after the reorganization.

In the *Talbot Mills* case the taxpayer was a corporation which, prior to its recapitalization, had a capital stock of five thousand shares of the par value of $100 or $500,000. All of the stock with the exception of some qualifying shares was held by members, through blood or marriage, of the Talbot family. In an effort to adjust the capital structure to the advantage of the taxpayer, the company was recapitalized just prior to the beginning of the fiscal year in question, by each stockholder surrendering four-fifths of his stock and taking in lieu thereof registered notes in aggregate face value equal to the aggregate par value of the stock retired. This amounted to an issue of $400,000 in notes to the then stockholders. These notes were dated October 2, 1939, and were payable to a specific payee or his assignees on December 1, 1964. They bore

annual interest at a rate not to exceed 10% nor less than 2%, subject to a computation that took into consideration the net earnings of the corporation for the fiscal year ended last previous to the annual interest paying date. There was, therefore, a minimum amount of 2% and a maximum of 10% due annually and between these limits the interest payable varied in accordance with company earnings. The notes were transferable only by the owner's endorsement and the notation of the transfer by the company. The interest was cumulative and payment might be deferred until the note's maturity when "necessary by reason of the condition of the corporation." Dividends could not be paid until all then due interest on the notes was satisfied. The notes limited the corporation's right to mortgage its real assets. The notes could be subordinated by action of the Board of Directors to any obligation maturing not later than the maturity of the notes. For the fiscal year in question the maximum payment of 10% was made on the notes.

The payments in question on corporate obligations were for the years in the *Kelley* case, 1937, 1938 and 1939; in the *Talbot Mills* case for the year 1940. Both corporations deducted the payments as interest from their reports of gross income under statutory sections and regulations set out in the footnote.[2] The applicable statutes and

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[2] Internal Revenue Code:

"SEC. 23. Deductions from Gross Income. In computing net income there shall be allowed as deductions:

* * * * *

"(b) Interest.—All interest paid or accrued within the taxable year on indebtedness . . ."

"SEC. 115. Distributions by Corporations. (a) Definition of Dividend.—The term 'dividend' when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or

regulations were identical for all periods. The Commissioner asserted deficiencies because the payments were considered dividends and not interest.

There is not present in either situation the wholly useless temporary compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering*, 293 U. S. 465. The demonstrated possibility of sales by the holders of the obligations to persons other than stockholders alone proves the differentiation. As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.

From the foregoing statements of facts, it appears that the characteristics of all the obligations in question and the surrounding circumstances were of such a nature that it is reasonably possible for determiners to reach the conclusion that the secured annual payments were interest to creditors in one case and dividends to stockholders in the other case. In the *Kelley* case there were sales of the debentures as well as exchanges of preferred stock for debentures, a promise to pay a certain annual amount, if earned, a priority for the debentures over common stock, the debentures were assignable without regard to any transfer of stock, and a definite maturity date in the reasonable future. These indicia of indebtedness support the Tax Court conclusion that the annual payments were interest on indebtedness. On the other hand, in the *Talbot*

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(2) out of the earnings or profits of the taxable year . . ."

Treasury Regulations 103:

"SEC. 19.23 (b)-1. Interest.—Interest paid or accrued within the year on indebtedness may be deducted from gross income . . .

* * * * *

"So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. . . ."

See Revenue Acts of 1936 and 1938, 49 Stat. 1648, 1659, 52 Stat. 447, 460, and Treasury Regulations 94, Art. 23 (b)-1, and 101, Art. 23 (b)-1.

Mills case, the Tax Court found the factors there present of fluctuating annual payments with a two per cent minimum, the limitation of the issue of notes to stockholders in exchange only for stock, to be characteristics which distinguish the Talbot Mills notes from the Kelley Company debentures. Upon an appraisal of all the facts, the Tax Court reached the conclusion that the annual payments by Talbot Mills were in reality dividends and not interest.

We think these conclusions should be accepted by the Circuit Courts of Appeals and by ourselves. Judicial review of Tax Court decisions depends upon the Internal Revenue Code, § 1141 (c) Powers (1). It reads:

"To affirm, modify, or reverse.—Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require."

It is only recently that we gave careful consideration to the problems of review of Tax Court decisions. *Dobson* v. *Commissioner*, 320 U. S. 489. That opinion emphasized that our interpretation of Congressional purpose, in enacting the statute, just quoted, for judicial review of Tax Court decisions, was that Congress intended to leave to the final determination of the Tax Court all issues which were not clear-cut questions of law.

The provisions for review are the same now as they were when enacted in 1926. Congress, and all others interested, were then well aware of the difficulties in drawing a line between questions of fact and questions of law.[3]

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[3] Compare Thayer, A Preliminary Treatise on Evidence at the Common Law, Ch. V, with Holmes, The Common Law, pp. 123-129. 1 Holdsworth, History of English Law, 298, 312; Dickinson, Administrative Justice, c. III, p. 55:

"In truth, the distinction between 'questions of law' and 'questions of fact' really gives little help in determining how far the courts will review; and for the good reason that there is no fixed

The legislation was upon a subject, the collection of the revenue, in which federal administrative finality had been given wide scope.[4] The Tax Court was originally established to "secure an impartial and disinterested determination of the issues involved,"[5] so that the taxpayer and the Government would have an independent review of the position of either on tax demands before payment of the tax or foreclosure of an asserted deficiency. Two years later its success was recognized by committee commendation and the enlargement of the finality of its decisions from "prima facie evidence of the facts contained therein" to reviewability only "if the decision of the Board is not in accordance with law."[6] As to the mischief which the limitation of the scope of judicial review was to cure, we find only the words of the committee reports.[7] Without

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distinction. They are not two mutually exclusive *kinds* of questions, based upon a difference of subject-matter. Matters of law grow downward into roots of fact, and matters of fact reach upward, without a break, into matters of law. The knife of policy alone effects an artificial cleavage at the point where the court chooses to draw the line between public interest and private right."

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[4] R. S. § 3224; 26 U. S. C. § 3653; *Heiner* v. *Diamond Alkali Co.*, 288 U. S. 502; *Cary* v. *Curtis*, 3 How. 236.

[5] S. Rep. No. 398, 68th Cong., 1st Sess., p. 9.

[6] H. Rep. No. 179, 68th Cong., 1st Sess., p. 8; 44 Stat. 110, § 1003 (b); H. Rep. No. 1, 69th Cong., 1st Sess., p. 17; S. Rep. No. 52, 69th Cong., 1st Sess., p. 34.

While establishing a complete system of review, it has all along been recognized that the taxpayer could secure a jury trial of fact issues, if he chose to pay and sue for recovery. S. Rep. No. 52, 69th Cong., 1st Sess., p. 37. *Dobson* v. *Commissioner*, 320 U. S. 489, 495.

[7] H. Rep. No. 1, 69th Cong., 1st Sess., p. 19-20:

"*Court review—Questions of fact and law.*—The procedure is made to conform as nearly as may be to the procedure in the case of an original action in a Federal district court. Inasmuch as the complicated and technical facts governing tax liability require a determination by a body of experts, the review is taken directly to an appellate court, just as, for instance, in the case of orders of the Federal Trade Commission, and orders of the Secretary of Agriculture under the packers and stockyards act. In view of the grant of exclusive power to the board finally to determine the facts upon

a clearer description by Congress of the intended line to separate reviewability of the Tax Court decisions from non-reviewability, courts must interpret the review statute, as best they can, to accomplish the declared Congressional purpose of adequate control of administrative action without substituting judicial opinion for that of the Tax Court upon the evidence. Note 7, *supra*.

The illustrations in the report, note 7, *supra*, are legal questions without doubt, except the possibility that the words "application of the statute or any regulation having the force of law" may be thought to give a reviewing court power to pass upon the Tax Court's conclusion from the primary or evidential facts. So that, in the present cases, it might be said to be a question of law as to whether the primary facts adduced made the payments under consideration dividends or interest. But we think such conclusion gives inadequate weight to the purpose of the Tax Court. The finality of the Tax Court's rulings was being enlarged by the 1926 Act. The then Board was spoken of as an impartial and independent tribunal of experts "for the determination of tax liabilities as between the Government and the taxpayer." H. Rep. No. 1, 69th Cong.,

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which tax liability is based, subdivision (b) of section 914 limits the review on appeal to what are commonly known as questions of law. The court upon review may consider, for example, questions as to the constitutionality of the substantive law applied, the constitutionality of the procedure used, failure to observe the procedure required by law, the proper interpretation and application of the statute or any regulation having the force of law, the existence of at least some evidence to support the findings of fact, and the validity of any ruling upon the admissibility of evidence (see subdivision (a) of section 907 and subdivision (b) of section 914). [§ 1003 (b) of the Act as passed.] The court, therefore, may adequately control the action of the administrative officer or agency, but will not be burdened with the duty of substituting its opinion for that of the board upon the evidence."

The reference to the Federal Trade Commission and to the Packers and Stockyards Act was to show the choice of a circuit court of appeals for judicial review and was not intended to suggest the adoption for the Tax Court review of any standard of scope of review.

1st Sess., p. 17. There would hardly need to be experts in tax affairs to decide questions of dates or amounts or values or to calculate rates. Their usefulness lies primarily in their ability to examine relevant facts of business to determine whether or not they come under statutory language. Adequate reason for the use of the word "application" of course exists in situations where true legal questions arise, as in whether an act applies to transfers antecedent to its enactment or to income or estate taxes from trusts or to situations which involve conflicts of law. There is nothing in the context in which the word "application" is used which suggests to us that it should be given its widest connotation.

These cases now under consideration deal with well understood words as used in the tax statutes—"interest" and "dividends." They need no further definition. *Equitable Life Assurance Society* v. *Commissioner*, 321 U. S. 560; *Deputy* v. *DuPont*, 308 U. S. 488, 498. The Tax Court is fitted to decide whether the annual payments under these corporate obligations are to be classified as interest or dividends. The Tax Court decisions merely declare that the undisputed facts do or do not bring the payments under the definition of interest or dividends.[8] The documents under consideration embody elements of obligations and elements of stock. There is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. So-called stock certificates may be authorized by corporations which are really debts, and promises to pay

[8] Dickinson, Administrative Justice, 312; Paul, Dobson v. Commissioner: The Strange Ways of Law and Fact, 57 Harv. L. R. 753, 826, 832, 840; Brown, Fact and Law in Judicial Review, 56 Harv. L. R. 899, 904.

may be executed which have incidents of stock. Such situations seem to us to fall within the *Dobson* rule.[9]

This leads us to affirm the *Talbot Mills* decree and to reverse the *Kelley* judgment.

It is so ordered.

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[9] Compare *Helvering* v. *F. & R. Lazarus Co.*, 308 U. S. 252, 255; *Wilmington Trust Co.* v. *Helvering*, 316 U. S. 164, 167; *Helvering* v. *Stock Yards Co.*, 318 U. S. 693, 700, 702; *Equitable Society* v. *Commissioner*, 321 U. S. 560, 563; *Commissioner* v. *Scottish American Co.*, 323 U. S. 119.

APPENDIX D

GREGORY *v.* HELVERING, COMMISSIONER OF INTERNAL REVENUE.

CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

No. 127. Argued December 4, 5, 1934.—
Decided January 7, 1935.

* * * * * * * * * * *

Opinion of the Court

MR. JUSTICE SUTHERLAND delivered the opinion of the Court.

Petitioner in 1928 was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the Monitor Securities Corporation. For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a "reorganization" under § 112 (g) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 818, set forth later in this opinion. To that end, she caused the Averill Corporation to be organized under the laws of Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation as capital net gain the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that

if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction.

The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance and must be disregarded, held that petitioner was liable for a tax as though the United corporation had paid her a dividend consisting of the amount realized from the sale of the Monitor shares. In a proceeding before the Board of Tax Appeals, that body rejected the commissioner's view and upheld that of petitioner. 27 B. T. A. 223. Upon a review of the latter decision, the circuit court of appeals sustained the commissioner and reversed the board, holding that there had been no "reorganization" within the meaning of the statute. 69 F. (2d) 809. Petitioner applied to this court for a writ of certiorari, which the government, considering the question one of importance, did not oppose. We granted the writ.

Section 112 of the Revenue Act of 1928 deals with the subject of gain or loss resulting from the sale or exchange of property. Such gain or loss is to be recognized in computing the tax, except as provided in that section. The provisions of the section, so far as they are pertinent to the question here presented, follow:

"Sec. 112. (g) *Distribution of stock on reorganization.*—If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized. . . .

"(i) *Definition of reorganization.*—As used in this section . . .

"(1) The term 'reorganization' means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, . . ."

It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *United States* v. *Isham*, 17 Wall. 496, 506; *Superior Oil Co.* v. *Mississippi*, 280 U. S. 390, 395-6; *Jones* v. *Helvering*, 63 App. D. C. 204; 71 F. (2d) 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" [§ 112 (g)] of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment

of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Judgment affirmed.

INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	1
Statute and regulations involved	2
Statement	3
Argument	7
Conclusion	18

CITATIONS

Cases:

Armston, W. H., Co. v. *Commissioner*, 188 F. 2d 531	8
Bazley v. *Commissioner*, 331 U.S. 737	7, 10, 17
Botany Mills v. *United States*, 278 U.S. 282	7
Commissioner v. *Ashland Oil & R. Co.*, 99 F. 2d 588, certiorari denied, 306 U.S. 661	9
Commissioner v. *Court Holding Co.*, 324 U.S. 331,	7, 10, 14, 16, 17
Commissioner v. *Tower*, 327 U.S. 280	17
Commissioner v. *Transport Trad. & Term. Corp.*, 176 F. 2d 570, certiorari denied, 338 U.S. 955	17
Deputy v. *duPont*, 308 U.S. 488	7, 13
Dobson v. *Commissioner*, 320 U.S. 489	15
Fairfield S. S. Corp. v. *Commissioner*, 157 F. 2d 321, certiorari denied, 329 U.S. 774	14, 17
1432 Broadway Corp. v. *Commissioner*, 160 F. 2d 885	16
Friedman v. *Delaney*, 171 F. 2d 269, certiorari denied, 336 U.S. 936	13
Gregory v. *Helvering*, 293 U.S. 465	7, 10, 16, 17
Griffiths v. *Commissioner*, 308 U.S. 355	7
Giurlani, A., & Bro. v. *Commissioner*, 119 F. 2d 852	13
Heller v. *Commissioner*, 147 F. 2d 376, certiorari denied, 325 U.S. 868	9
Helvering v. *Limestone Co.*, 315 U.S. 179	9, 14, 15
Higgins v. *Smith*, 308 U.S. 473	7, 17
Illinois Agricultural Hold. Co. v. *Commissioner*, 131 F. 2d 583	8, 12, 13

Cases—Continued

Page

Ingle Coal Corp. v. *Commissioner*, 174 F. 2d 569, 6, 8, 12, 13, 17
Ingle Coal Corp. v. *Commissioner*, 10 T.C. 1199, 6, 12 13, 17
Interstate Transit Lines v. *Commissioner*, 319 U.S. 590 ..... 7, 12
Janeway v. *Commissioner*, 147 F. 2d 602..... 16
Kaufmann v. *Commissioner*, 175 F. 2d 28..... 17
Kelly, John, Co. v. *Commissioner*, 326 U.S. 521... 15
Lewis v. *Commissioner*, 176 F. 2d 646..... 14
Limericks, Inc. v. *Commissioner*, 165 F. 2d 483.... 8, 17
Long Island Drug Co. v. *Commissioner*, 111 F. 2d 593, certiorari denied, 311 U.S. 680..... 8
Meurer Steel Barrel Co. v. *Commissioner*, 144 F. 2d 282, certiorari denied, 324 U.S. 860..... 17
Minnesota Tea Co. v. *Helvering*, 302 U.S. 609 .... 7, 9, 10
Paramount-Richards Th. v. *Commissioner*, 153 F. 2d 602 ..... 8, 11, 13
Regensburg v. *Commissioner*, 144 F. 2d 41, certiorari denied, 323 U.S. 783..... 8, 11
Stanwick's, Inc. v. *Commissioner*, 190 F. 2d 84.... 8
Survaunt v. *Commissioner*, 162 F. 2d 753..... 9, 14
Talbot Mills v. *Commissioner*, 326 U.S. 521..... 15
Thomas Flexible Coupling Co. v. *Commissioner*, 158 F. 2d 828, certiorari denied, 329 U.S. 810... 13
United States v. *Cumberland Pub. Serv. Co.*, 338 U.S. 451 16
United States v. *Lynch*, 192 F. 2d 718, certiorari denied, 343 U.S. 934 17
Welch v. *Helvering*, 290 U.S. 111..... 12, 13
White v. *Fitzpatrick*, 193 F. 2d 398, certiorari denied, 343 U.S. 928 13
Wichita Term. El. Co. v. *Commissioner*, 162 F. 2d 513 17

Statutes:

Internal Revenue Code of 1939:
Sec. 23 (26 U.S.C. 1952 ed., Sec. 23).. 2, 7, 12, 15, 16
Sec. 112 (26 U.S.C. 1952 ed., Sec. 112)..... 9
Sec. 115 (26 U.S.C. 1952 ed., Sec. 115)..... 7

Miscellaneous:

	Page
Paul, "Step Transactions," *Selected Studies on Federal Taxation* (Second Series), pp. 200-254..	14
Treasury Regulations 111, Sec. 29.23(a)-1.....	3

In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 279

INGLE COAL CORPORATION, PETITIONER

v.

THE UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. App. 1a-11a) is reported at 127 F. Supp. 573.

JURISDICTION

The judgment of the Court of Claims was entered on January 11, 1955. (Pet. App. 1a; R. 81.) A motion for rehearing filed by the taxpayer was denied on May 3, 1955. (R. 105.) The petition for a writ of certiorari was filed on July 29, 1955. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255.

QUESTION PRESENTED

Taxpayer's predecessor, a family corporation, mined coal lands under a lease which obligated it

to pay a stipulated royalty to the lessor. The stockholders caused its assets and liabilities to be transferred to themselves in liquidation, and contemporaneously retransferred them to a newly formed corporation (taxpayer), which continued to carry on the business of the predecessor and in which their stock interests were the same. As part of the arrangement taxpayer agreed to pay the stockholders a "royalty" in addition to that paid the lessor. Did the Court of Claims err in holding that the additional royalty payments did not constitute ordinary and necessary business expenses deductible from taxpayer's gross income under Section 23(a)(1)(A) of the Internal Revenue Code of 1939?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23 [As amended by Sec. 121(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount ex-

> pended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> (26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> Sec. 29.23(a)-1. *Business Expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business * * *.

STATEMENT

The facts as stipulated and found by the Court of Claims (Pet. App. 11a-29a) may be summarized as follows:

The Ingle Coal Company, taxpayer's predecessor, was engaged in the business of mining coal on lands held under a lease which obligated it to pay the lessor (Wasson) a royalty of five cents per ton of coal mined. On June 30, 1942, it had 2,000 shares of stock outstanding, all of which were owned by members of the Ingle family—two brothers, two sisters, and the children of the brothers. The brothers were the officers of the company, and

they and their sisters constituted four of the five directors. (Pet. App. 11a-13a, 23a.)

In the spring of 1942 Ingle Coal Company received an offer of $1,000,000 for its assets. This offer was rejected, one of the reasons being the substantial amount of income tax liability which the company and its stockholders would incur if the properties were sold. (Pet. App. 13a.) Instead, the stockholders adopted a plan to form a new corporation which would take over the assets and liabilities of the existing one. On June 30, 1942, they held a stockholders' meeting at which it was resolved that the corporation liquidate and distribute its property to them or their nominees, and they directed the officers to transfer the property to the newly organized taxpayer corporation (Ingle Coal Corporation) as their nominee. (Pet. App. 14a-16a.) Immediately thereafter the stockholders of the old company met as organizers and directors of the new. At this meeting they received from themselves on behalf of taxpayer a proposal to convey all the assets of the old company in consideration of the issuance of taxpayer's stock to them in proportion to their stock holdings in the old company, the assumption by taxpayer of all the liabilities of the old company (including the obligation to pay royalties under the existing Wasson lease), and, in addition, an agreement by taxpayer to pay them in proportion to their stock holdings an additional royalty of five cents per ton on all coal produced. This proposal was contemporaneously accepted on behalf of taxpayer, and documents evidencing the

arrangement were executed by the old company, the new company, and the stockholders. (Pet. App. 16a-21a.)

The plan was adopted and consummated for the purpose of reducing taxes, assuring a more definite income to the sister stockholders, and permitting them to retain an interest in the business (the over-riding "royalty" contract) despite a transfer of the stock. (Pet. App. 29a.)

After consummation of the plan taxpayer continued to carry on the business of the predecessor, paid the lessor of the property the agreed royalty which the predecessor had contracted to pay, and in addition paid to its stockholders the over-riding "royalty" which it had contracted to pay them under the plan. In 1943 one of the two sister stockholders died; her stock was sold in equal portions to the brother stockholders and their children, and her rights in the overriding royalty contract were distributed to her heirs. In 1944 the other sister donated some of her stock, and in 1946 sold the remainder, to the children of the brothers. As a result of these transfers the entire stock of taxpayer was held in equal one-half shares by the two brothers and their respective families. The heirs of the deceased sister, and the living sister, retained their interest in the overriding royalty contract. (Pet. App. 24a-25a.)

Taxpayer had substantial net earnings in each of the years 1942 to 1948. Its accumulated earnings amounted to $185,596 at the end of 1947 (after charging to surplus $750,000 paid for a new mine),

and $675,195 at the end of 1948. In addition to the over-riding royalty payments to the stockholders, it paid dividends in each of the years 1944 to 1948. (Pet. App. 27a-28a.)

In its income tax returns for 1942 and 1943, taxpayer deducted from its gross income, in addition to the royalty paid to the lessor, the amounts paid to its stockholders as over-riding royalties. The Commissioner allowed as deductions the payments to the lessor, but disallowed those made to the stockholders. The Tax Court sustained the Commisioner's determination (10 T.C. 1199) and the Court of Appeals for the Seventh Circuit affirmed (174 F. 2d 569). (Pet. App. 2a-3a, 26a-27a.)

In its income tax returns for 1947 and 1948 (the taxable years here involved), taxpayer deducted from its gross income, in addition to the royalties paid the lessor, the royalties paid the brother stockholders, the living sister, and the heirs of the deceased sister. These amounted to $42,761 for 1947, and $34,223 for 1948. The Commissioner again disallowed the over-riding royalty payments, and the resulting deficiency in tax was paid. A timely refund claim was filed by taxpayer, and after the expiration of six months the present action was instituted. (Pet. App. 25a-28a.)

The Court of Claims held that the prior final decision of the Seventh Circuit Court of Appeals (174 F. 2d 569), involving the years 1942 and 1943, did not operate to estop taxpayer from litigating its present claim for the years 1947 and 1948. On the merits, it held that the so-called over-riding

royalty payments were not ordinary and necessary business expenses of the taxpayer corporation deductible under Section 23(a)(1)(A) of the Internal Revenue Code of 1939, but in substance constituted non-deductible dividend distributions. (Pet. App. 1a-9a.) Two judges dissented. (Pet. App. 9a-11a.)

ARGUMENT

The decision below, applying settled principles to the particular facts of this case, is correct. There is no conflict and no occasion for further review.

1. Section 23(a)(1)(A) of the Internal Revenue Code of 1939, *supra*, pp. 2-3, authorizes a deduction from gross income of "ordinary and necessary" business expenses. Section 115(a) defines a dividend as any distribution by a corporation to its shareholders out of accumulated or current earnings. That a payment is labeled an "expense" or is contractually incurred does not render it deductible; the "origin and nature" of the liability to pay, not its legal form, determine the right to the deduction. *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 594; *Deputy* v. *duPont*, 308 U.S. 488, 494-496; *Botany Mills* v. *United States*, 278 U.S. 282, 292. This rule is but a corollary of the fundamental principle that taxation is concerned with economic realities rather than legal formalities.[1] And where, as here, the payments

[1] *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *Higgins* v. *Smith*, 308 U. S. 473; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Gregory* v. *Helvering*, 293 U. S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *Bazley* v. *Commissioner*, 331 U. S. 737.

are by a family corporation to its controlling stockholders, the transaction is subject to special scrutiny lest what is essentially a non-deductible dividend distribution be disguised as a deductible expense. In harmony with these principles the Courts of Appeals in a long line of decisions have held that payments by a corporation to some or all of its stockholders may in reality constitute dividend distributions notwithstanding that they are made pursuant to a contract and are treated as expenses on the corporate books. See, *e.g.*, *Stanwick's, Inc.* v. *Commissioner,* 190 F. 2d 84 (C.A. 4th); *W. H. Armston Co.* v. *Commissioner,* 188 F. 2d 531 (C.A. 5th); *Ingle Coal Corp.* v. *Commissioner,* 174 F. 2d 569 (C.A. 7th); *Limericks, Inc.* v. *Commissioner,* 165 F. 2d 483 (C.A. 5th); *Paramount-Richards Th.* v. *Commissioner,* 153 F. 2d 602, 604 (C.A. 5th); *Regensburg* v. *Commissioner,* 144 F. 2d 41 (C.A. 2d), certiorari denied, 323 U.S. 783; *Illinois Agricultural Hold. Co.* v. *Commissioner,* 131 F. 2d 583 (C.A. 7th); *Long Island Drug Co.* v. *Commissioner,* 111 F. 2d 593 (C.A. 2d), certiorari denied, 311 U.S. 680.

As is plain from its opinion, the court below applied the controlling principles to the undisputed facts of this case. Taxpayer's predecessor was the lessee of coal mines under a long-term lease which obligated it to pay the lessor a stipulated royalty. Its stockholders, directors, and officers consisted of closely related members of the Ingle family. At the end of June, 1942, pursuant to a preconceived plan, the stockholders resolved to liquidate the

corporation, took legal title to its assets, and contemporaneously retransferred the assets to a newly formed corporation (taxpayer), which assumed the liabilities of the predecessor corporation and issued its stock to them in the same proportions as their former stock holdings. As an integral part of the plan, the stockholders caused taxpayer corporation to contract to pay them in proportion to their stock holdings a "royalty," in addition to the royalty payable to the lessor. Upon consummation of the plan taxpayer had the same assets and liabilities as its predecessor, except for the added obligation to pay an over-riding royalty to the stockholders. The net effect of the entire transaction was to substitute one wholly-owned corporation for another and, in the process, saddle the successor corporation with an additional "expense" payable to the stockholders. The liquidation distribution of the predecessor's assets did not give the stockholders real and independent ownership of the assets. It was merely an intermediate and transitory step in a corporate reorganization, the stockholders acting as conduits of the assets from the old corporation to the new. See Section 112(g)(1)(D) of the Internal Revenue Code of 1939; *Helvering* v. *Limestone Co.*, 315 U.S. 179, 184-185; *Survaunt* v. *Commissioner*, 162 F. 2d 753, 756-759 (C.A. 8th); *Heller* v. *Commissioner*, 147 F. 2d 376 (C.A. 9th), certiorari denied, 325 U.S. 868; *Commissioner* v. *Ashland Oil & R. Co.*, 99 F. 2d 588, 591 (C.A. 6th), certiorari denied, 306 U.S. 661; cf. *Minnesota Tea Co.* v. *Helvering*, 302

U.S. 609; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Bazley* v. *Commissioner*, 331 U.S. 737.

Had the additional "royalty" payments to the stockholders been made by the predecessor corporation itself, they undoubtedly would have represented dividend distributions, not deductible business expenses, for the corporation already had the right to use its property without paying any more for that use than the royalty it had previously contracted to pay to the lessor of the property. The same would have been true had the predecessor corporation directly transferred its property to the successor corporation, without the formal intervening liquidation distribution to the stockholders. That ownership of the property was circuitously routed from the predecessor to the successor corporation through the stockholders, who momentarily acquired bare legal title, cannot produce a different tax result. To hold otherwise would exalt artifice above reality. *Commissioner* v. *Court Holding Co., supra; Minnesota Tea Co.* v. *Helvering, supra; Gregory* v. *Helvering*, 293 U.S. 465; *Bazley* v. *Commissioner, supra.*[2] On the record here presented the court below was fully justified in concluding (Pet. App. 8a-9a) that the indirect trans-

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[2] In the words of this Court in the *Minnesota Tea Co.* case, *supra*, pp. 613-614—

> A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident * * *. The relation of the stockholders to the matter was that of a mere conduit.

fer had no genuine business purpose, but was a "device designed to convert nondeductible dividends into deductible royalty payments;" that the over-riding royalty payments to the stockholders should be "treated the same as if the plaintiff's predecessor corporation" had agreed to make the payments; and that the agreement "lacked real consideration, was gratuitous, and was in reality an arrangement for a distribution of dividends or profits in the guise of royalty payments."

True, in 1943 and 1944 the shares of the two sister stockholders (who together owned fifty percent of the stock) were transferred in equal portions to the two brother stockholders and their children, with the result that thereafter fifty percent of the additional royalty payments went to members of the family group who were no longer stockholders. (Pet. App. 24a.) But these transfers obviously did not serve to convert the other fifty percent of the payments, made to the brothers and their children, who remained stockholders, from dividend distributions into deductible business expenses.[3] And for the reasons pointed out by the court below (Pet. App. 9a), they did not serve to bring the fifty percent of the payments made to

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[3] It is settled that distributions of corporate earnings to stockholders may constitute dividends notwithstanding that they are not in proportion to stock holdings and that some of the stockholders do not participate in the distribution. *Regensburg* v. *Commissioner, supra; Paramount-Richards Th.* v. *Commissioner, supra.* Taxpayer admittedly had accumulated earnings during the taxable years in excess of the royalty payments in question. (Pet. App. 25a-26a, 28a.)

the non-stockholder members of the family within the ambit of deductible business expenses. In short, the question here is essentially no different from that presented in *Ingle Coal Corp.* v. *Commissioner,* 10 T.C. 1199, affirmed, 174 F. 2d 569 (C.A. 7th), involving the very same transaction and the taxable years 1942 and 1943. The decision below is in full accord with the decisions of the Tax Court and the Court of Appeals in that case.

2. Even assuming *arguendo* that the court below was obliged to view the payments in question as business expenses, rather than as dividend distributions, the payments still would not qualify for deduction as "ordinary and necessary" expenses within the meaning of Section 23(a)(1)(A). "To be deductible as business expenses, payments made must be both ordinary *and* necessary." *Illinois Agricultural Hold. Co.* v. *Commissioner, supra,* p. 585. See also *Welch* v. *Helvering,* 290 U.S. 111. And the "mere fact that the expense was incurred under contractual obligation does not of course make it the equivalent of a rightful deduction under Section 23(a)." *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, 594. Furthermore, the claimed deduction must be examined in the light of the "now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Interstate Transit Lines* v. *Commissioner, supra,* p. 593. See also *Deputy* v. *duPont,* 308 U.S. 488; *Welch* v. *Helvering, supra.* This burden has not been met by taxpayer.

The additional royalty expense in question was not "necessary," since taxpayer's predecessor already had the right to mine coal on its property in consideration of the stipulated royalty payments to the lessor, and all of its assets and liabilities were transferred to taxpayer. The imposition upon taxpayer of the obligation to make additional royalty payments cannot be considered "necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful" (*Welch* v. *Helvering, supra,* p. 113); its assumption of that additional liability was purely gratuitous (*Thomas Flexible Coupling Co.* v. *Commissioner,* 158 F. 2d 828 (C.A. 3d), certiorari denied, 329 U.S. 810; *Friedman* v. *Delaney,* 171 F. 2d 269 (C.A. 1st), certiorari denied, 336 U.S. 936; *Illinois Agricultural Hold. Co.* v. *Commissioner, supra; Ingle Coal Corp.* v. *Commissioner, supra*). Nor can the payments be considered "ordinary" expenses in the requisite sense that they were "of common or frequent occurrence in the type of business involved" (*Deputy* v. *duPont, supra,* p. 495); nothing in the record even remotely suggests that the over-riding royalty expense which taxpayer undertook in favor of its stockholders was usual in taxpayer's type of business, or, for that matter, in any other type of business. *A. Giurlani & Bro.* v. *Commisisoner,* 119 F. 2d 852 (C.A. 9th); *Paramount-Richards Th.* v. *Commissioner, supra; Illinois Agricultural Hold. Co.* v. *Commissioner, supra; Ingle Coal Corp.* v. *Commissioner, supra.* See also *White* v. *Fitzpatrick,* 193 F. 2d 398 (C.A. 2d), certiorari denied, 343 U.S. 928.

3. Taxpayer is mistaken in its assumption (Pet. 8-9, 12) that the holding of the court rests upon a disregard of the existence of the taxpayer's corporate identity. The court below fully recognized the reality and permanency of the taxpayer corporation. However, it correctly refused to view the transitory liquidation distribution of the predecessor's assets to the stockholders, and the stockholders' simultaneous retransfer of the assets to the newly created taxpayer corporation, as separate and independent transactions for tax purposes; it properly treated the two transfers as component steps in a single integrated transaction. The doctrine that tax consequences flow from the business substance rather than the legal form of a transaction applies with full force in the case of a planned "step transaction," one of whose steps is a liquidation distribution of corporate assets to the stockholders. *Helvering* v. *Limestone Co.*, 315 U.S. 179, 184-185; *Commissioner* v. *Court Holding Co., supra; Survaunt* v. *Commissioner, supra; Lewis* v. *Commissioner,* 176 F. 2d 646 (C.A. 1st); *Fairfield S. S. Corp.* v. *Commissioner,* 157 F. 2d 321 (C.A. 2d), certiorari denied, 329 U.S. 774. See Paul, "Step Transactions," *Selected Studies on Federal Taxation* (Second Series), pp. 200-254. The basic fallacy in taxpayer's argument is that it treats a reorganization transfer of property from one corporation to another as if it were a sale or lease by the stockholders to a third party, merely because one of the procedural steps in the reorgani-

zation plan was a liquidation distribution to the stockholders.[4]

4. Taxpayer asserts (Pet. 6-9) conflict with *John Kelley Co.* v. *Commissioner,* and *Talbot Mills* v. *Commissioner,* 326 U.S. 521. However, those companion cases involved the quite different question of whether so-called interest payments by a corporation constituted deductible "interest * * * on indebtedness" within the meaning of Section 23(b), and the answer turned upon whether the instruments under which the payments were made (debentures in *Kelley,* notes in *Talbot*) in substance represented a creditor or a proprietary interest in the corporation. The Tax Court reached opposite conclusions in the two cases, although they presented essentially similar situations, and this Court held that its decision in each case was nevertheless entitled to affirmance since the question was one within the province of the fact-finding tribunal.[5]

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[4] As this Court stated in the *Limestone* case, *supra,* pp. 184-185—

> the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these [reorganization] sections of the revenue acts where they add nothing of substance to the completed affair. * * * Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan.

[5] While this Court applied the "Dobson rule" (*Dobson* v. *Commissioner,* 320 U. S. 489) governing the scope of appellate review of Tax Court decisions, and that rule has since been supplanted by the "clearly erroneous" rule, the *Kelley* and *Talbot* cases still stand for the proposition that the question is one of ultimate fact for the trial court, whose decision should

Those cases are not controlling, or even relevant, as to whether a particular payment constitutes an ordinary and necessary business expense within the purview of Section 23(a)—the problem here presented.[6] And even if they be regarded as apposite, they surely cannot afford taxpayer any comfort, for they demand affirmance rather than reversal of the trial court's decision in this case. See also *Commissioner* v. *Court Holding Co., supra; United States* v. *Cumberland Pub. Serv. Co.*, 338 U.S. 451.

Equally unfounded is taxpayer's contention (Pet. 6, 9-15) that the court below misapplied the decision in *Gregory* v. *Helvering*, 293 U.S. 465, and related cases. To begin with, the contention proceeds on taxpayer's mistaken notion (Pet. 8-9, 12) that the court below challenged the permanency of the taxpayer corporation. As already noted the Court of Claims recognized taxpayer's permanent existence, but properly refused to consider the fleeting ownership of the assets by the stockholders as anything more than an intermediate procedural step in the reorganization transfer of the predecessor's assets to the taxpayer. In any event, far from having erred in relying on *Gregory* and similar cases, as taxpayer charges, the court below correctly applied the fundamental principle there enunciated, *i.e.*, that tax liability depends

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not be disturbed if supported by substantial evidence. See *1432 Broadway Corp.* v. *Commissioner*, 160 F. 2d 885 (C.A. 2d); *Janeway* v. *Commissioner*, 147 F. 2d 602 (C.A. 2d).

[6] Even the dissenting opinion below makes no mention of the *Kelley* and *Talbot* cases.

upon the substance of a transaction viewed from beginning to end, not upon its formal component steps. While the principle was applied in *Gregory* to deny recognition of an ephemeral corporation, it has been applied by this Court and the Courts of Appeals in a variety of other contexts.[7] Indeed, the *Gregory* doctrine has many times been applied in denying tax recognition to a transitory liquidation distribution by a corporation to its stockholders—the very type of case in which taxpayer here urges it is inapplicable. *Commissioner* v. *Court Holding Co., supra; Commissioner* v. *Transport Trad. & Term. Corp.*, 176 F. 2d 570 (C.A. 2d), certiorari denied, 338 U.S. 955; *Fairfield S. S. Corp.* v. *Commissioner, supra; Meurer Steel Barrel Co.* v. *Commissioner*, 144 F. 2d 282 (C.A. 3d), certiorari denied, 324 U.S. 860; *Wichita Term. El. Co.* v. *Commissioner*, 162 F. 2d 513 (C.A. 10th); *Kaufmann* v. *Comissioner*, 175 F. 2d 28 (C.A. 3d).

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[7] See *e.g., Higgins* v. *Smith, supra; Griffiths* v. *Commissioner*, 308 U. S. 355; *Commissioner* v. *Court Holding Co., supra; Bazley* v. *Commissioner, supra; Commissioner* v. *Tower*, 327 U. S. 280; *Commissioner* v. *Transport Trad. & Term. Corp.*, 176 F. 2d 570 (C.A. 2d), certiorari denied, 338 U. S. 955; *Fairfield S. S. Corp.* v. *Commissioner, supra; Limericks, Inc.* v. *Commissioner, supra; Ingle Coal Corp.* v. *Commissioner, supra; United States* v. *Lynch*, 192 F. 2d 718 (C.A. 9th), certiorari denied, 343 U. S. 934.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1955.

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